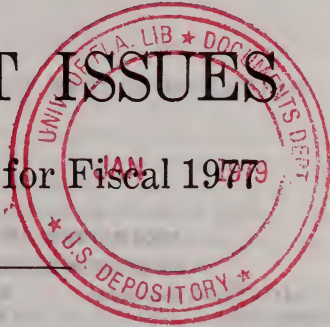


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BUDGET ISSUES

Staff Studies for Fiscal 1977



COMMITTEE ON THE BUDGET UNITED STATES SENATE

Inflation	1
Employment	25
Assistance to State & Local Governments..	61
Retirement & Disability Programs.....	87
U.S./U.S.S.R. Military Spending.....	125



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(II)

CONTENTS

	Page
Letter of Transmittal.....	vii

GOVERNMENT POLICIES TO REDUCE INFLATION

Preface.....	3
I. Summary.....	5
II. Costs and prices under direct Federal control:	
A. The Administration's budget proposals for fiscal 1977.....	6
B. Direct price effects of other Government programs.....	10
III. The effect of the budget on inflation and unemployment:	
A. The outlook.....	13
B. The impact of an income tax cut on inflation and unemployment.....	15
C. The impact on inflation and unemployment of direct cuts in costs.....	16
Appendix.....	18

Tables:

Annual rate of cost increase.....	8
Cost inflation in the budget.....	10
Inflation and unemployment on the 2 CBO growth paths.....	14
Estimated effect on price level and unemployment of various programs to reduce private costs.....	17
The composition of the percent of inflation.....	20

Charts and graphs:

Historical relation between inflation and unemployment.....	22
---	----

EMPLOYMENT

Preface.....	27
I. The problem and alternative solutions:	
A. The problem.....	29
B. Goals.....	30
C. Basic approaches and decisions.....	30
II. Growth: How fast?.....	31
III. The "direct response" of the Federal budget to unemployment:	
A. A variety of instruments.....	36
B. Enhanced employability and incentives.....	41
C. Income maintenance for the employable.....	44
D. Direct employment.....	49

IV

Appendix.....	Page 55
---------------	------------

Tables:

Unemployment and employment under two economic growth paths..	29
Difference in employment by age, sex, and race by achieving 6 percent rather than 5 percent average real output growth.....	33
Unemployment rates by race, sex, and age during the current recession..	34
Federal anti-employment instruments.....	37
The Federal direct response to unemployment.....	39
"Direct response" budget (Path A).....	40
"Direct response" budget (Path B).....	40
Demographic changes in the labor force and unemployment rolls....	41
Outlays from income support programs for the employable, 1976-1981..	45
Changes in characteristics of unemployment.....	55
Changes in the budget's direct response to unemployment from a targeted public employment program.....	58

Charts and graphs:

Distribution of the civilian labor force and recession-induced unemployment among age groups.....	32
Unemployment rates of household heads.....	35
Number of unemployed household heads.....	35
Distribution of the anti-unemployment budget outlays.....	38

FEDERAL ASSISTANCE TO STATE AND LOCAL GOVERNMENTS

Preface.....	63
I. Introduction and summary.....	65
II. Current programs and the President's proposals.....	66
III. Objectives of Federal assistance.....	70
IV. Fiscal year 1977 budget issues and options:	
A. General revenue sharing.....	74
B. Anti-recession assistance.....	75
C. Law enforcement assistance.....	80
D. Exclusion from Federal income taxes of interest on municipal bonds.....	81
E. The President's proposals for categorical grants.....	82
V. Conclusion.....	85

Tables:

Federal grants to State and local governments (outlays).....	67
Grant outlays by function.....	68
Cost of major Federal tax expenditures aiding State and local governments, fiscal years 1967 and 1976.....	68
Federal grants-in-aid outlays by function.....	70
Comparison of anti-recession programs.....	77
Comparison of President's policy for block grants proposals.....	83

TRENDS AND ISSUES IN FEDERAL RETIREMENT AND DISABILITY PROGRAMS

	Page
Preface.....	89
I. Summary.....	91
A. Social security.....	92
B. Medicare.....	93
C. Federal employee retirement.....	93
D. Other legislation.....	94
II. Importance of retirement and disability programs to fiscal policy.....	94
III. Relationships among retirement and disability programs.....	99
IV. Major policy issues:	
A. Financing social security in the short run.....	101
B. Long-run social security issues: Decoupling and financing.....	108
C. Protection against catastrophic health care costs.....	109
D. Federal service retirement and disability.....	111
E. Other pending legislation.....	116

• Tables:

CBO path B projections of current services outlays for retirement and disability programs, 1975-81.....	95
Caseloads and costs of Federal income assistance programs.....	97
Projections of the receipts and disbursements of OASDI trust funds, 1975-81.....	102
Savings under military retirement options.....	116

Charts and graphs:

Overlaps in beneficiary groups, fiscal year 1975.....	99
Overlaps in beneficiaries age 65 and over.....	100

U.S. AND U.S.S.R. MILITARY SPENDING

Preface.....	127
I. Introduction and summary.....	129
II. Soviet foreign/military policy.....	132
A. External security situation.....	134
B. Internal security considerations.....	139
III. Usefulness of U.S./U.S.S.R. military spending comparisons.....	143
A. Criticism of budget comparisons.....	143
B. Costing methodologies.....	144
C. Are the estimates useful?.....	146
IV. U.S./U.S.S.R. quantitative force comparisons: Cost implications for FY 1977 budget.....	148
A. Strategic offensive forces.....	149
B. Strategic defense forces.....	152
C. Theater nuclear forces.....	152
D. General purpose forces.....	154
E. Western Pacific/Asia deployment.....	165

Tables:

	Page
U.S./U.S.S.R. strategic delivery vehicles.....	149
U.S./U.S.S.R. strategic weapons.....	149
U.S./U.S.S.R. general purpose forces.....	154
NATO/Warsaw Pact balance.....	154
United States—	
ICBM 1977 budget proposals.....	150
Submarine-launched ballistic missiles.....	150
Strategic bomber forces and related systems.....	151
Strategic defense forces.....	152
Tank forces.....	155
Artillery.....	156
Helicopters.....	157
Surface ships.....	159
Surface combatants—weapons and equipment.....	160
Attack submarines.....	161
Air Force tactical air programs.....	162
Navy tactical aircraft.....	163
Tactical air missiles.....	164
Airlift/sealift forces.....	165

Charts and graphs:

U.S./U.S.S.R. nuclear capabilities—1975.....	152
--	-----

LETTER OF TRANSMITTAL

TO BUDGET COMMITTEE MEMBERS:

The papers published herewith were prepared, as you know, by the Budget Committee staff in connection with the Committee's consideration of the First Concurrent Resolution for Fiscal 1977. Each deals with one of the major underlying decisions we confronted in connection with the fiscal 77 resolution. I believe they should be available for further use by our Committee, and for use by other committees and Members as the Senate considers specific fiscal 77 spending legislation.

Government Policies To Reduce Inflation identifies policy decisions such as proposed changes in payroll taxes and certain subsidies that will directly affect prices. These decisions will have a more important influence on the rate of inflation in fiscal 1977, while physical and human resources are under-utilized, than will the rate of economic expansion.

The relationship among overall fiscal policy, spending for employment and education, and income maintenance programs is investigated in the paper entitled *Employment*.

Approximately 45 percent of the Federal programmatic response to unemployment is in the form of financial assistance for the unemployed, primarily unemployment compensation. Another 43 percent is spent on education and training programs that increase employability. Only 12 percent is for programs such as public employment, public works, and countercyclical revenue sharing that directly increase employment.

The paper describes a public employment program, targeted on low-income families who are receiving unemployment compensation and/or welfare, providing relatively low salaries for only 12 months. The analysis shows that the net budget cost (i.e., net addition to the deficit) would be between \$2,100 and \$2,500 per job per year.

Federal Assistance to State and Local Governments is an effort to place key fiscal 1977 spending decisions on Federal grants-in-aid in the context of broad Federal-State-local fiscal relations. State and local government are a significant sector of the economy, accounting for over 15 percent of GNP. A substantial portion of their revenue—on the order of 22 percent—comes from Federal grants, which are found in 12 of the 17 budget functions. Thus Federal grants affect a wide range of State and local government activities. They also affect the response of State and local budgets to economic cycles, and consequently, the effectiveness of Federal stabilization policy.

Trends and Issues in Federal Retirement and Disability Programs describes the major fiscal issues Congress faces in the provision of cash and health-care benefits to the aged, retired, disabled, and survivors. These programs—which include social security, medicare, civil service and military retirement systems, supplemental security income (SSI), and veterans' compensation and pension benefits—account for 36 percent of all Federal outlays (\$150 billion in fiscal 1977 out of \$413 billion total). The revenues collected for social insurance trust funds from which most of these benefits are paid will amount to \$107 billion in fiscal 1977, or 30 percent of the total \$362 billion.

The most pressing issue concerns the possibility of a short-term deficit in the social security trust funds. The paper indicates that the chance of such a deficit materializing is far from certain and there are many ways to deal with such an eventuality. The paper also describes the long-term financing problem and how it relates to various short-term approaches.

U.S.-U.S.S.R. Military Spending explores some of the major policy pressures behind the substantial growth in strategic and general purpose forces provided in the fiscal 1977 budget. These pressures include the security perceptions of the Soviet Union and the comparative force strengths of NATO and the Warsaw Pact as well as that of the two super powers themselves. The report also analyzes the usefulness of comparing U.S. and U.S.S.R. military spending in evaluating the adequacy of the U.S. defense budget.

These studies have been prepared by the Senate Budget Committee staff with the assistance of the Congressional Budget Office. The studies were undertaken to aid the Budget Committee in the decisions it must make in these areas with respect to fiscal policy and budget priorities.

Nothing in these studies should be interpreted as representing the views or recommendations of the Budget Committee or any individual Member thereof.

Sincerely,

EDMUND S. MUSKIE,
Chairman.

GOVERNMENT POLICIES TO REDUCE INFLATION

(1)

GOVERNMENT POLICIES TO REDUCE INFLATION

Preface

This paper was prepared to aid the Senate Budget Committee in formulating the First Concurrent Resolution on the Budget for Fiscal Year 1977.

The paper was prepared by Donald Nichols and Edmond Haggart with the assistance of Karen Schubeck and Martin Asher of the Senate Budget Committee staff. Michael Owen and Frank deLeeuw of the Congressional Budget Office provided the econometric analyses.

EDMUND S. MUSKIE,
Chairman.

Index

The following is a list of the names of the persons who have been associated with the work of the American Red Cross in the United States and its territories. The names are arranged in alphabetical order of the last name. The names of the persons who have been associated with the work of the American Red Cross in the United States and its territories are as follows:

James S. Brown
Chairman

GOVERNMENT POLICIES TO REDUCE INFLATION

I. Summary

Fiscal policymakers are well aware of the short run trade-off between inflation and unemployment. The threat of renewed inflationary pressures is a deterrent to policies which would hasten the return to full employment and full production. In the present unusual circumstances when both unemployment and inflation are high, policies are needed which will cut prices and stimulate recovery simultaneously.

This paper suggests that policy opportunities of this kind are available through modest changes in the 1977 budget. Specifically, the President has proposed to change several prices and costs which are now directly controlled by the Federal Government. Some of his proposed changes would increase prices, such as the 0.3 percent increase in Federal social security payroll taxes and the increase in unemployment insurance taxes. Some proposed changes would lower prices, such as his proposals for Federal pay and Medicare cost control.

Taken together, these changes, upon which Congress must act this year, can reduce the general price level by more than one-half of 1 percent, compared with what would otherwise be. Additional opportunities for price cutting by the Federal Government could reduce prices by another one-half percent at least, without considering secondary effects of price reductions on wage rates.

These proposals also have an indirect effect on prices through their effect on economic activity. A cut in payroll taxes, for example, would reduce unit labor costs and therefore tend to reduce the rate of inflation; but it would also stimulate economic activity, and this would tend to cause prices to rise. Both effects are considered here. Inflation caused by direct changes in prices or costs is called *cost inflation*, while that caused by changes in economic activity is called *demand inflation*.

Section 1 examines the effect of some Federal policy options on cost inflation. Section 2 addresses the effect of these price-cutting options on demand inflation and compares their stimulative consequences with those caused by equivalent cuts of personal income taxes.

The price cutting options are shown to have a more favorable effect on both prices and jobs. The model used here suggests that there are feasible policies that will cut prices by eight-tenths percent in the first year and unemployment by over 0.4 percent in the second year. The disadvantages of using the price system in this fashion are noted.

The options in this paper are considered independent from their effect on the Federal deficit. The conclusion is that cost cutting policies which would reduce Federal revenues by \$10 billion have a more favorable impact on inflation and unemployment than, for example, a personal income tax cut which would reduce Federal revenues by the same amount. Moreover, it should be noted that a policy to reduce costs and inflation directly will permit adoption of more stimulative fiscal and monetary policies that will also reduce unemployment more quickly.*

II. Costs and Prices Under Direct Federal Control

A. THE ADMINISTRATION'S BUDGET PROPOSALS FOR FISCAL 1977

The President's fiscal 1977 budget proposal suggests changes in many prices and costs. These are outlined here and an estimate of their impact on inflation is given.

PAYROLL TAXES

The President proposed that the *social security payroll tax* be increased by 0.3 percent on both employers and employees on January 1, 1977. This is estimated to yield \$3.3 billion in fiscal 1977 (in the first 9 months of 1977), and \$4.4 billion over the full year. That half of the tax which is paid by employers is an increase in labor costs, and in the short run these costs are usually passed on to consumers in the

* Minority footnote:

A strong word of caution is required about concluding that fiscal stimulus in addition to that resulting from these policies should be adopted. The favorable short-run effects of these policies on inflation does not mean it is safe to apply still more stimulus—to get back to the original inflation rate and benefit from doubly improved real growth.

There are three reasons for this caution:

- (a) The quantitative reductions in the rate of inflation are rather uncertain. This is merely a realization that the numbers are best estimates. If not increasing the unemployment payroll tax reduces the rate of inflation by 0.25 of a percentage point, this does not mean that added stimulus totaling a 0.25 increase in the inflation rate—by rule of thumb giving 0.5 added reduction in the unemployment rate—should be adopted. We can, however, safely conclude that adopting such a policy can be expected to produce at least as much real growth as tax reduction producing deficit of equal magnitude. In addition, the rate of inflation can be expected to be lower. A policy that would have similar effects and was not mentioned in the paper is a *wage tax credit*.
- (b) The reduced rate of inflation resulting from use of policies that influence prices directly may be only a short-run phenomenon; the longer-run effects on the rate of inflation will be considerably less, possibly zero. Therefore, to apply stimulus *in addition* to that provided by the direct price policy may well result in a higher rate of inflation in the longer run.
- (c) The short-run trade-off between inflation and unemployment is not constant throughout the possible range of unemployment rates and real growth rates. In general, the lower the unemployment rate or the more rapid the rate of real growth, the greater will be the increase in the rate of inflation from added budget/or monetary stimulus. Therefore, the added stimulus in addition to that provided by the direct price policies would affect that inflation rate more than it would in the absence of the direct price policies.

form of higher product prices. The extra \$2.2 billion in costs represent about 0.2 percent of employee compensation in calendar 1977.

The proposed increase in the *unemployment insurance tax* would have a similar effect on costs. This proposed tax increase of \$2.8 billion (\$2.1 billion in fiscal 1977), will be paid entirely by employers and would raise labor costs by a full quarter of a percent.

The speed with which these cost increases would be transformed into price increases is uncertain. One recent study suggests that 75 percent of the increase would be passed on in the first year.¹

There is also some evidence that firms maintain their traditional profit margins on cost increases of this kind. If this is the case, the long-run effect on prices could be greater than if the costs were simply passed through to consumers.

Ignoring the markup effect, the Gross National Product deflator would increase by 0.19 percent in calendar 1977 as a result of the proposed increases in payroll taxes and by more than 0.26 in the long run. The effect on the Consumer Price Index—a better measure of the cost of living—would be slightly larger.

The President's proposals to reduce corporate and personal income taxes may offset to some extent the effect on prices of the increases in payroll taxes. The evidence, however, does not suggest that this offset will be significant, at least in the short run.

PAY INCREASES FOR FEDERAL EMPLOYEES

The President has proposed to limit Federal pay increases to 5 percent in October 1976. Assuming that comparability requirements would call for an increase of about 8.5 percent by that date, and assuming further that restoration would have been made of the remaining 3.7 percent increase that was denied in October 1975, this proposal would keep Federal salaries \$3.5 billion below the level they would otherwise attain.

Since Federal pay increases affect the Gross National Product deflator but not the Consumer Price Index, the effect of this proposal on the measured rate of inflation depends on which index is being used. No one's cost of living will be lower as a direct effect of the pay restraint. Yet the visibility of the Federal pay raise suggests that it may have a significant effect on other wage decisions. Thus the effect of pay restraint on the cost of living is indirect and its size is not estimated here. Its omission does not imply that the indirect effect would be insignificant.

The GNP deflator would be 0.19 percent lower if the President's proposal to restrict wage increase to 5 percent were adopted than with no pay restraints.

USER TAXES

The President has proposed to increase a wide variety of prices and taxes that are levied on the users of government facilities.

Postal rates would rise by \$307 million more than if the subsidy to second-, third- and fourth-class mail were extended at current rates. The Postal Service has requested the extension.

¹ Charles L. Schultze, "Falling Profits, Rising Margins and the Full Employment Profit Rate," *Brookings Papers on Economic Activity*, 1975:2 pp. 449-469.

Mass transit subsidies would be reduced. The President has proposed that only 50 percent of the funds provided to localities for mass transit aid in fiscal 1977 be used to subsidize fares. It is estimated that 90 percent of the \$648 million requested for transit formula grants would have been used for fare subsidies without this restriction. Fares will be \$258 million higher because of the restriction.

The sum of all user tax increases of this kind would be more than \$700 million.² If these costs were passed through to users with no markup, the GNP deflator would increase by 0.04 percent.

MEDICAL CARE

The President has proposed to limit the cost increases for medical care that can qualify for reimbursement under Medicare. Hospital cost increases of 7 percent and physician fee increases of 4 percent would be permitted. The proposed cost increases are about six percentage points less than their rate of increase in 1975. If, in the absence of the proposed controls, these prices would continue to increase at the higher 1975 rates during fiscal 1977, then the price reductions due to this proposal alone would be worth \$1.18 billion in fiscal 1977. The budget message argues that total Medicare costs would be lower by \$2.2 billion as a result of the entire Medicare proposal. The remaining budget savings would be due to a predicted reduction in utilization rates.

It is not clear whether this proposal would affect medical care costs in the rest of the economy since no controls are proposed for medical prices other than those to be reimbursed under Medicare.

It should be noted that this proposal differs from others that have been mentioned in that it involves direct controls over private prices. The other proposals concern changes in prices and costs that are already publicly determined.

Price controls on medical care were reasonably effective during the economic stabilization period of 1971 to 1974. Except for this period, hospital service costs have grown steadily relative to other prices for the last 20 years. The trend has been most evident since the enactment of Medicare and Medicaid in 1965. The table shows the abnormal behavior of prices in the medical care industry.

Table 1.—ANNUAL RATES OF COST INCREASE

Item	1969-71	ESP ¹	1st half 1975
CPI.....	4.6	6.4	7.5
Medical care.....	6.7	4.3	12.5
Medical care services.....	7.6	4.9	12.8
Semiprivate room.....	13.0	5.7	15.0
Physician fees.....	7.4	4.0	11.6

¹ Economic stabilization period.

² Other minor increases included in the \$700 million are the imposition of \$80 million of waterway user taxes and an increase in uranium prices that are charged to private utilities of \$91 million.

While medical price increases were suppressed during the stabilization periods, institutional changes which would promote price reduction did not take root at that time. The measures employed by hospitals to restrain inflation were targeted toward short-term efficiencies such as restraining employee salary increases, and freezing staffing ratios, rather than to more rational control of long-term costs. The exceptionally large increase in medical prices in 1975 was, in part, a realization of cost increases that had been suppressed during the economic stabilization period.

It should be noted that non-Federal medical care costs would not fall, and could even be *increased* as a result of this proposal. This would happen if hospitals did not hold down costs and raised charges to non-Medicare patients by enough to cover the cost increases for all patients. If the prices charged to non-Medicare patients are not affected by this proposal, it would reduce the GNP deflator by 0.06 percent.

GRANTS TO STATES

The reduction in grants to State and local government would have an uncertain effect on budget decisions in those jurisdictions. A part of the reduction could result in lower spending, and a part in higher taxes. If sales taxes, property taxes, or other excise taxes were increased, prices and costs would rise directly. The size of these tax increases has been estimated to be about one-third of the size of the reduction in general grants, and one-fourth the size of categorical grants.³ Thus an \$8 billion reduction in grants would cause these taxes to rise by about \$2.0 billion and would cause the deflator to increase by about 0.11 percent.

TOTAL INFLATIONARY EFFECT

Each of the proposals described above represents a request by the Administration that may be subject to controversy in the Congress. The proposals involve changes from current policy budget levels, from established procedures, or from prevailing prices that are being charged by government enterprises. Factors other than inflation, such as program efficiency, will also have to be considered.

The total direct effect on the GNP deflator of these proposals is estimated to be 0.68 percentage points as shown in Table 2. That is, this index would be higher by more than 0.68 percent if the inflationary option were chosen in every case than if the alternative were chosen. Since some of the Administration proposals would reduce prices, the net effect of the Administration's position would be to raise the deflator by about 0.14 percent, though the effect on private prices and costs could be more than twice that. These estimates are summarized in the table below.

It should be noted that the indirect effect on costs could also be substantial, though these estimates have been excluded from the table. Wage increases could moderate in the future, for example, if large price increases could be avoided in the shorter term. The Notes

³ Edward M. Gramlich and Harvey Galper, "State and Local Fiscal Behavior and Federal Grant Policy." Brookings Papers on Economic Activity, 1973:1, pp. 15-58.

to Table 2 below describe how the estimates were derived. Effects are shown for both the GNP deflator—which covers the entire economy including the government sector—and for the private sector alone.

Table 2.—COST INFLATION IN THE BUDGET

[Percent]

Item	Effect on GNP deflator	Effect on private costs
Proposed increase in employee payroll taxes of \$5,000,000,000-----	+0. 26	+0. 27
Limit Federal pay increase to 5 percent-----	— . 19	-----
Increase in user taxes by \$736,000,000-----	+ . 04	+ . 04
Medical care price controls-----	— . 06	-----
Reduction in telephone excise tax (mandated in existing law)-----	— . 02	— . 02
Increase in State sales taxes that could result from a reduction in grants of \$8,000,000,000---	+ . 11	+ . 11
Potential inflationary impact of the President's proposals-----	+ . 14	+ . 40
Total difference between <i>most</i> inflationary and <i>least</i> inflationary options-----	+ . 68	+ . 44

NOTES TO TABLE 2

The estimates of the direct effect of lower taxes and prices on the price level were calculated as follows. For the GNP deflator, the dollar values of the proposed changes were divided by the level of GNP that is expected for the period. The GNP estimates are those provided in the President's budget. The payroll tax proposal would be effective January 1, 1977. It was divided by \$1,890 billion, the projected level of GNP for calendar 1977. Other proposals were calculated under the assumption that they became effective on October 1, 1976. A GNP of \$1,839 billion was used for these proposals, since that is the level of GNP projected for fiscal 1977.

The effects on the private cost of living were estimated by adjusting the GNP estimates for two factors. (1) Compensation of Federal employees was subtracted leaving an adjusted GNP of \$1,770 billion for fiscal 1977 and \$1,823 billion for calendar 1977. (2) Those prices not paid by the private sector—such as Federal salaries—were not included in the private cost of living.

B. DIRECT PRICE EFFECTS OF OTHER GOVERNMENT PROGRAMS

The proposals discussed above include only those changes from current policies that have been specifically proposed by the President. A wide range of additional options exist if Federal policy were to deliberately seek out price-reducing measures.

First, and most obvious, wherever an increase in prices has been proposed, decreases are an alternative to be considered. Payroll taxes, for example, can be reduced rather than increased and prices would then be pushed down rather than up.

Second, some additional budget proposals exist which could affect inflation but which do not involve direct controls over prices or costs. The President has proposed, for example, that \$870 million worth of materials be sold from strategic military stockpiles. The sales would restrain increases in the prices of these materials by an undetermined amount.

Third, the budget also affects prices in many ways in areas where the President has not called for major changes. The list of changes above for which inflationary price tags have been estimated was selected because they require major budgetary decisions for fiscal 1977. The scheduled expiration of the telephone excise tax could be accelerated, for example. Interest subsidies for home buyers could be expanded. Subsidies could be increased for AmTrak or the Postal Service. Gasoline, tobacco, and alcohol taxes could be reduced.

Fourth, new budget options could be proposed that are specifically designed to cause prices to fall. Grants could be given to State and local government in exchange for reductions in sales taxes. These programs could be voluntary, though it is unlikely that any State would turn down a chance to reduce its own citizen's taxes, particularly if it thought that the Federal grants would be permanent. A \$10 billion program of this kind would lower the Consumer Price Index by a full percentage point in its first year. The more broadly based GNP deflator would fall by less. The Consumer Price Index also has a larger effect on private wage decisions than the GNP deflator, so that the feedback from such price cuts on future wage decisions could be substantial.

Fifth, non-budgetary government programs can be used to change prices directly. The President has proposed that transportation regulations be changed so that shipping rates can fall. Natural gas and petroleum prices are determined in large part by the Federal Government. These prices have a substantial impact on the general price level. It has been estimated that the difference between the highest and lowest proposals for petroleum prices that were seriously considered in 1975 involved two full percentage points in the price index.

PRICES AND EFFICIENCY

Prices serve an important purpose in guiding productive resources into those activities which are of greatest value in a free enterprise economy. The policy of direct cost reduction which has just been described would dull the effectiveness of the price system if the cuts were pushed too far, particularly if only a small number of products was involved. Prices fall when postal rates are cut, for example. But if postal rates are cut too far, the public would use the mail to a greater extent than they should. The Postal Service would then have to expand and the public benefits of the expansion would likely be less than the additional costs. Some feel that postal rates are already too low and that the subsidy should be ended.

For this reason it is best to concentrate major cost reductions on those taxes which have a general impact on all products. Cuts in the sales or the payroll tax, for example, would not distort private allocation decisions while lower postal rates might.

A dilemma arises in cases like that of natural gas where a higher price is needed in order to have consumers economize on its use. If however, the higher price cannot be offset by cuts in other publicly controlled prices, and if the higher price cannot be accompanied by more fiscal and monetary stimulus, then a rejection of the price increase can be considered on the grounds that it will add to both inflation and unemployment. The inefficiency caused by having workers idle should be

weighed against the inefficiency caused by having occasional shortages of natural gas. The impact on inflation of price increases of this kind is also an important criterion to consider.

In this regard, one must question the overriding importance of having employers pay for the unemployment compensation system, or for the use of the payroll tax to finance the Social Security System. Grants from general revenue may violate the principles of the systems. But this effect must be weighed against the adverse effect on inflation and unemployment of the payroll taxes that support these systems.

LONG-RUN EFFECT

These price policies will reduce the price level directly and therefore will reduce the rate of inflation in the short-run. But the price cuts are "one-shot" and will have no direct effect on future inflation rates unless they are repeated. The long-run effect of this policy depends on its effect on wage rates.

Historically, wage settlements have responded to changes in price inflation. If wage inflation were to moderate in response to the one-shot reduction in prices, then the long-run rate of inflation could be reduced. The lower wage inflation would reduce costs further leading to a further response of prices. The wage-price spiral would be partially unwound.

Even with a beneficial response from wages, direct price cuts should not be viewed as an alternative to responsible monetary and fiscal policies, but as complementary to them. The direct price cuts provide an opportunity to reduce the inflation rate permanently without changing the rate of real economic growth. If monetary and fiscal policies were not trimmed accordingly when full employment was approached, the economy would soon revert to its original, higher rate of inflation. In this regard, the price cuts provide an opportunity to adjust from our present inflationary situation to a less inflationary one, but they cannot, by themselves make the less inflationary situation permanent.

SUMMARY

The budget has a major direct influence on prices. The rate of inflation could be reduced by a point or more through moderate changes in prices and costs that are directly under the control of the government. New programs could be devised to spread the effect of the direct price reductions more broadly and to increase the size of the general impact on prices without seriously distorting other program objectives. The reduction in inflation would be temporary unless monetary and fiscal policies were adjusted to take advantage of the possibility that would be created for a permanent reduction in inflation.

Minority Addendum

Fiscal policy and monetary policy interact with private sector demands to determine the total demand for goods and services, and the growth in that demand over time. The growth in demand, together with the recent history of wage and price increases, are the major determinants of the rate of inflation at any point in time.

The growth in demand—as it affects prices and shapes the history of wage and price changes—becomes the dominant factor in determining the rate of inflation in the long run. The long run growth of demand is highly dependent on the rate of growth of the money supply. A major point of difference among economists is how *quickly* the current demand growth affects the rate of inflation. Some economists believe monetary and fiscal restraints on demand growth have more immediate effects on the rate of inflation.

The Budget Committee strongly affects the growth of total demand by recommending overall fiscal policy and by influencing monetary policy through fiscal policy and associated budget deficits.

III. *The Effect of the Budget on Inflation and Unemployment*

In this section, estimates of the impact of cost-cutting options on inflation and unemployment are discussed. The report concludes that reductions in directly controlled costs could reduce the unemployment rate more than would an income tax cut of the same budgetary cost. The lower rate of cost inflation would be partially offset by a higher rate of demand inflation that would result from the larger economic expansion. But the estimates indicate that the net effect would be to reduce inflation and unemployment at the same time. The resulting level of unemployment and inflation would depend on many other factors, the most important of which may be monetary policy.

A. THE OUTLOOK

No one has been able to forecast prices very accurately, particularly in recent years when special inflationary factors other than the level of economic activity have been of such major importance. Another world oil price rise could change the standard forecast by several percentage points. A bad harvest due to drought in the Southern Plains would have a visible, but smaller impact. Barring unforeseen special circumstances of this kind, the outlook is roughly as follows.

UNDERLYING INFLATION

Wage increases appear to be stabilizing in the 7 to 9 percent range. After remaining relatively constant for almost 5 years, wage-inflation increased when wage and price controls were eliminated in April 1974. From a previous rate of about 6 percent per year, wage increases rose at a rate of more than 12 percent in late 1974 and early 1975. The worst of that surge appears to be over and a new rate in the 7 to 9 percent range has taken hold for the last several months. This is the assessment given to the Budget Committee by Secretary of Labor Usery in his testimony of February 26, 1976.

Wage increases in that range would normally be accompanied by price increases of about 6 to 7 percent. This appears to be the standard forecast for the next several years, and this report will use it as a measure of underlying inflation. This forecast assumes that the recovery will not be aborted by a low level of growth of the money supply.

DEMAND INFLATION

With unemployment rates in the 7 percent range and with utilization of plant in the 80 percent range, there can be no inflation due to excess aggregate demand. The demand for output will remain below the Nation's ability to produce for the next several years. Most of the inflation that occurs in that period will be due to factors other than demand. Slack demand should allow the overall inflation rate to decline and the pace of that decline will depend on the level of demand.

The Congressional Budget Office's (CBO) *Five Year Budget Projections* describes two alternative growth paths: (A) a path which averages 5 percent real growth between now and 1981 and (B) a 6-percent path for the same period. No discussion of the policies needed to attain these paths is given. According to CBO, the rate of inflation should stabilize at about 6.6 percent per year along the fast path and gradually fall to 5 percent along the slow path.

The purpose of the two CBO growth paths is to point out the effect of economic assumptions on the budget projections. No discussions of the monetary or fiscal policies needed to attain these alternative paths is given. It appears that money growth substantially above the upper range of current Federal Reserve targets would be needed to meet these paths in the next few years. Despite the limitations of the two paths, they do permit a reasonable assessment of the impact on inflation of a more rapid rate of economic growth.

The inflation rate is higher along the fast path than it is on the slow path because resources are used more intensively. In particular, unemployment rates are lower and wage increases are higher along the fast path. This is due, in part, to the more rapid growth in the money supply that takes place along the fast growth path. The difference between the paths is displayed in the following table.

INFLATION AND UNEMPLOYMENT ON THE 2 CBO GROWTH PATHS

	Fast path (A)		Slow path (B)	
	Unemployment	Inflation	Unemployment	Inflation
1976-----	7.4	6.7	7.7	6.7
1977-----	6.4	6.6	7.5	6.1
1978-----	5.4	6.6	7.1	6.0
1979-----	4.8	6.6	6.7	5.5
1980-----	4.5	6.6	6.3	5.0
1981-----	4.5	6.6	5.9	5.0
Average-----	5.5	6.7	6.9	5.7

Between 1976 and 1981, the fast path would produce an unemployment rate that averages 1.4 points lower and an inflation rate that averages 1 point higher than the slow path. *Note that inflation continues to decline under both paths, but not as quickly on the fast path.* The total difference between the two paths amounts to an incredible \$1,078 billion of GNP over the 6 years.

In short, the underlying inflation rate of 7 percent can be slowly reduced by gradually restraining demand, but with an enormous cost in terms of unemployment and production. The risk of an outbreak of demand inflation is minimal when resources are underutilized and growth rates are not excessive. Inflation does not accelerate even along the fast CBO growth path. Given the enormous cost of reducing demand inflation, it is important that all opportunities to reduce cost inflation be examined.

B. THE IMPACT OF AN INCOME TAX CUT ON INFLATION AND UNEMPLOYMENT

The CBO provided estimates for this report that a permanent cut in the personal income tax of \$10 billion would reduce the unemployment rate by about 0.2 points within 2 years. The rate of inflation would be increased by less than 0.1 after 5 years as a result of the tax cut. These estimates are consistent with estimates published elsewhere by CBO.¹

A rule of thumb that derives from this calculation is that for moderate changes in demand, the short-run effect on unemployment is about twice that on inflation. Every 0.2 percent that the unemployment rate falls is associated in the long run with an increase in the inflation rate of 0.1 percent. *This rule of thumb is a useful guide when unemployment rates are in the 7-8 percent range. As unemployment rates fall, the inflationary impact will be larger than this rule suggests.*

It should not be assumed from this estimate that inflation must increase if income taxes are cut. The 0.1 percent of inflation that would result from the income tax cut represents a change from what would otherwise take place. If inflation rates would otherwise fall by 0.5 percent, they would still fall with the enactment of a 10-billion-dollar income tax cut, but only by 0.4 percent. Similarly, the reduction in the unemployment rate of 0.2 percent is in addition to the reduction that would take place without the cut.

The rule of thumb relating change in inflation to changes in unemployment permits us to calculate the cost of reducing inflation by restricting demand. At current levels of unemployment, an increase in the unemployment rate of 0.2 percent would be associated with a reduction in real GNP of about \$9 billion. This would be associated with a reduction in the inflation rate of 0.1 percentage points. If this rule of thumb is valid for somewhat larger variations in demand, then the cost of reducing inflation by one full percentage point by restraining demand growth is 2 percent in unemployment and \$90 billion in output. Cost reductions have a much smaller price tag as is shown below.

Longer-run benefits associated with a slower rate of inflation are difficult to quantify. They include the greater *likelihood* that restrictive policies which could induce recession will not be forthcoming at a later date.

¹ See Congressional Budget Office, *Recovery: How Far and How Fast?* Congress of the United States, September 1975.

C. THE IMPACT ON INFLATION AND UNEMPLOYMENT OF DIRECT CUTS IN COSTS

A reduction in the employer payroll tax would stimulate demand just as a reduction in the income tax would. This would tend to cause prices to rise. But the payroll tax is also a part of costs, and when costs fall, prices tend to fall as well. Which of these two effects is larger? That question is considered in this section.

The many different costs that could be cut directly by government would have very different impacts on inflation and unemployment. Their direct inflationary effect was described in Table 2. Their indirect effect depends on several other factors. (1) It depends on the speed with which firms pass through their cost changes to consumers. (2) It depends on whether changes in final prices get magnified by having an effect on future wage decisions. (3) It depends on the amount of funds that are transferred from the public to the private sector in order to bring about the reduction in costs. The different programs described above could differ in these three ways, and some of the differences are hard to predict. The effect of the cost reductions on unemployment will also vary with the same three factors.

The last factor is the easiest to identify. A transfer of funds from the public to the private sector has an effect on demand inflation and unemployment that is easily separated from the effect that derives directly from the price reductions listed in Table 2.

A payroll tax cut would provide funds to the private sector. So would an increase in the Postal subsidy, the mass transit subsidy, or a reduction in sales or excise taxes. The reduction in private prices that are regulated by the government, such as the trucking transport costs or natural gas prices, would not transfer any funds to the private sector. And the price controls on Medicare reimbursements and the wage controls on Federal employees would reduce the funds that are transferred to the private sector. The effects of the cost reductions on demand inflation vary directly with the amount of funds being transferred, and are about the same per dollar as the effects described above for the transfer of funds through a reduction in the income tax. That is, the aggregate demand pressure will be about the same whether the funds are transferred by reducing taxes or reducing prices. In some programs—such as the proposal to control Medicare costs—it should be noted that demand inflation and cost inflation are reduced at the same time.

CBO was asked to perform three different calculations to determine the effects on unemployment and inflation of different kinds of cost reductions (1) The effect of a payroll tax reduction was estimated under the assumption that a change in the employer tax would affect final prices as fast as would any other change in labor costs, (2) the effect of a direct reduction in consumer sales taxes was estimated under the assumption that this would have no subsequent impact on wage decisions; and (3), the same calculation was performed as in (2) except that it was assumed that future wage inflation would respond to the direct reduction in prices the way it has historically. All calculations were performed for a hypothetical \$10 billion program. The effects for smaller programs can be estimated by reducing these figures proportionally.

The effects of these hypothetical changes are summarized in Table 3. One striking result from the table is the power of cost reduction as an economic stimulus. Cost reduction would stimulate the economy in two ways. It would increase the number of dollars transferred from the government to the private sector by the same amount as the income tax cut. But since it would also lower prices, the purchasing power of all private incomes and assets would be increased. The impact of this second effect on unemployment would be quite powerful, according to the estimates provided. Direct price cuts are a powerful way to stimulate the economy and when unemployment rates are high, the price cuts are not offset in all cases by higher prices that result from the higher level of economic activity that takes place.

Table 3.—ESTIMATED EFFECT ON PRICE LEVEL AND UNEMPLOYMENT OF VARIOUS PROGRAMS TO REDUCE PRIVATE COSTS

	Effect on unemployment rate in 2d year	Effect on price level	
		1st year	5th year
		Percent	Percent ¹
(1) \$10,000,000,000 cut in personal income tax-----	-0.2	0	+0.5
(2) \$10,000,000,000 cut in employer payroll tax-----	- .4	- .2	0
(3) \$10,000,000,000 cut in consumer prices with no effect on future wage inflation-----	- .5	- .8	+ .2
(4) \$10,000,000,000 cut in consumer prices with normal effect on future wage inflation-----	- .6	-1.0	- .3

¹ The figure reported in col. 3 is the estimated cumulative effect on prices over 5 years. It is not the estimated rate of inflation in the 5th year, but the sum of the inflation rates for the 5-year period.

Reductions in payroll taxes would work with a lag, but their final impact would be substantial. CBO estimates that 43 percent of a reduction in employer payroll taxes would be reflected in lower prices in the first year and 47 percent in the second year. After 5 years, this initial price reduction would be just offset by the inflationary effect of the expansion. Unemployment would fall by almost twice as much under this plan as it would if ordinary income taxes had been cut, however. The unemployment rate would be 0.4 lower after 2 years, compared to a reduction of 0.2 that would result from the \$10 billion income tax cut. The strong possibility that cuts in employer payroll taxes could reduce unemployment twice as much as an equivalent cut in income taxes with the same effect on prices makes payroll tax cuts a policy worth serious study.

The numbers in Table 3 come from a model of inflation; a process that is not well understood. Therefore, the estimates must be evaluated with caution. Estimates of *changes* in inflation resulting from *changes* in policy, however, are more likely to be correct than estimates of the level of inflation (the level depending on other factors such as food harvests and OPEC oil prices.)

INFLATION AND UNEMPLOYMENT

Direct cost reduction was shown to be a powerful stimulus. Because of this, it would be dangerous to use this policy when unemployment rates were already low. Since the price cuts are a powerful stimulus, they would create shortages if the economy were already at full employment. For this reason, the policy of cost reduction has not received much attention before. It would have been inappropriate to apply this policy to previous postwar inflations. It is the unique nature of the present inflation that makes this policy appropriate today.

The policy has been used before, however. Recently, France cut its value added tax in an attempt to reduce inflation without increasing unemployment. The United States does not have a similar Federal tax that could be cut at this time.

Most Federal excise taxes have already been eliminated. Many were reduced in 1965 in an effort to curb inflation. The others were reduced during the first term of the Nixon Administration for the same purpose. The economy was much closer to full employment in those years and thus the policy was less appropriate for reducing the inflation that was taking place then than it would be today.

SUMMARY

Reductions in prices and costs controlled by the government offer a promising opportunity to reduce the unemployment rate without increasing the inflation rate. Most other sources of growth, whether public or private, would lead to more inflation than if the growth were stimulated by direct cost reduction by government. The only other source of growth that would have the same beneficial effect on inflation would come from price cuts in other economic sectors. If bountiful harvests caused food prices to fall or if problems within OPEC caused petroleum prices to fall, the economy would be stimulated and prices could fall at the same time. But with these special factors beyond government control, direct reductions in costs by government should be considered.

Through moderate changes in a variety of prices and costs that are directly controlled by the Federal Government, the inflation rate and the unemployment rate can be reduced at the same time. These constrictions must be balanced in the long run by reductions in the levels of monetary and fiscal stimuli if the reduction in inflation is to be maintained. The 1977 budget deliberations present an important opportunity to begin a policy of this kind.

Appendix

THE INFLATION OF 1973-75

The simultaneous existence of inflation and unemployment makes the economic problem of the last few years a unique post-war experience. It was argued above that this unique situation calls for a policy of cost reduction on the part of government since such a policy can

attack inflation and unemployment at the same time. In order to gain perspective on the present policy dilemma, the history of the recent inflation will be discussed here.

The data to be presented show that—

- (a) the inflation was started in a few special sectors;
- (b) it eventually spread to other sectors of the economy; and
- (c) that as a result, the underlying rate of inflation is now quite high by historical standards.

It is always difficult to separate cause from effect when interpreting economic history. One plausible interpretation of the data is that the inflation was caused by a group of special factors that increased prices and costs in the sectors in question, and that it was not caused by an excessively stimulated economy. The increase in costs tended to drain purchasing power from the economy so that unemployment rose with the inflation rather than declining as it would if the inflation were due to too much demand.

While this interpretation is consistent with the data, it should be noted that price controls were in effect through much of the period, and that they provide an important qualification to any conclusions that are drawn. This problem is discussed further below.

THE COMPOSITION OF THE RECENT INFLATION

The data presented in Table 4 break down the inflation into several components—food, energy, imports, and mortgage interest costs—for each 6-month interval since late 1972. Inflation seemed to be under control in late 1972. Over the last 6 months of that year, the Consumer Price Index (CPI) increased at a rate of 3.71 percent per year. That was about two points lower than its level of 3 years before. The inflation was distributed relatively evenly over the various components of the index. Price controls were in effect and seemed to be working. The goal of the controls was to get the inflation rate below 3 percent and, for a few months in late 1972, this was accomplished.

The trouble began in early 1973, when prices of uncontrolled food and energy products began to increase at double-digit rates. While the rest of the economy did not experience this inflation, the average price level including food and energy rose at a rate of 8.2 percent as measured by the CPI. Within that average, the food component rose at a rate of 23.1 percent and the energy components rose at a rate of 11.4 percent. All other factors together rose at a rate below 4.3 percent.

In late 1973, the divergence among product prices was even more pronounced. The four special factors that are considered in this section—food, energy, mortgage interest costs, and imports—were responsible for more than 80 percent of the inflation during the last 6 months of that year despite the fact that they comprise only 40 percent of the index. Food prices went up at a 17-percent rate, energy prices at a 22-percent rate, mortgage interest costs at a 40-percent rate, and imports other than food and fuel at a 20-percent rate. All other prices—about 60 percent of the total index—increased at less than 4.5 percent. Despite the lack of a pervasive inflation, the CPI increased at a rate of 9.43 percent.

Table 4.—THE COMPOSITION OF THE PERCENT OF INFLATION**I. INFLATION OVER 6-MONTH INTERVALS EXPRESSED AT ANNUAL RATES**

	July- Dec. 1972	Jan.- June 1973	July- Dec. 1973	Jan.- June 1974	July- Dec. 1974	Jan.- June 1975
CPI inflation-----	3.7	8.2	9.4	12.5	11.9	6.8
CPI food-----	4.9	23.1	17.1	12.3	12.1	5.6
CPI energy-----	5.8	11.4	22.4	43.0	3.5	13.3
CPI mortgage interests---	7.4	-1.5	39.8	13.1	30.2	1.9
Imports-----	3.2	4.3	19.5	23.1	27.6	9.9
Residual-----			4.5	11.6	9.7	7.3

II. PERCENT OF INFLATION DUE TO EACH FACTOR

Food-----	29.6	61.4	42.8	24.3	25.1	20.5
Energy-----	9.3	8.2	14.0	20.7	2.2	13.4
Mortgage interest-----	7.3	- .7	14.2	4.2	9.9	1.2
Imports-----	53.8	31.1	9.1	8.1	10.0	6.3
Residual-----			19.9	42.7	52.8	58.6
Total CPI inflation--	100.0	100.0	100.0	100.0	100.0	100.0

III. RELATIVE IMPORTANCE OF EACH SECTOR

Food-----	0.24785
Energy-----	.06964
Mortgage interest-----	.04385
Imports-----	.04448
Residual-----	.59418
Total-----	1.00000

NOTES TO TABLE 4

(a) The weights in Part III of the Table for food, energy, and mortgage interest costs reflect the relative importance of these sectors in the Consumer Price Index in December 1974 as reported by BLS. These weights change over time as inflation proceeds unevenly, and the figures in sections I and II reflect these changes.

(b) The energy index is the weighted sum of the separate CPI components for gasoline and motor oil, fuel oil and coal, and gas and electricity.

(c) The mortgage interest cost index is derived as the difference between the special CPI index excluding mortgage interest and the entire CPI, using the appropriate weights.

(d) The index for imports less food and fuel is derived from Table D of the *September 1975 Survey of Current Business* (p. 44). No separate import component appears in the CPI, so this index which depends on balance of payments data is used. Its weight of 0.04448 is the average ratio of non-food, non-fuel imports to GNP over this period. The weight is not varied over the different time periods in the table above.

The import index is not available for 1972, so there is no import index reported for the first two time periods in the table.

(e) The selection of data presented in the table represents one of many ways to separate the inflation rate into its various components. Another way is to use the GNP deflators. In principle, this would give a more accurate indication of the sources of inflation, but even the GNP data are not collected in such a way as to make the division a simple one.

The problem with the CPI is that the final components contain many intermediate products. The CPI for food, for example, measures retail food prices. But these prices include large costs for packaging, processing, and transportation.

There is a lot more than farm output in the CPI food index, and there is some reason to believe that these other factors were responsible for part of the recent increase in food prices.

On the other hand, energy is an input into most forms of production, so that much of the inflation that is reported in the table as taking place in the residual industries is really due to higher energy costs. Similarly, interest costs are much more important than indicated in the table since the table only measures mortgage interest costs.

In total, the special factors isolated in the table represent some over and under estimates of the importance of those factors. Other studies which use other data confirm the general pattern of the inflation described in the table.

In each of the highly inflationary sectors, special circumstances caused shortages of the commodities in question. Bad harvests worldwide and the emergency of Japan as a major world food customer greatly increased the demand for American food. The oil embargo cut-off a major U.S. source of petroleum and environmental restrictions caused low sulfur coal to sell at a premium. Import prices soared, particularly raw materials prices, as worldwide demand expanded at an unusually high rate. This was due partly to the growing importance of Japan as a raw materials customer and partly to the rare phenomenon of a simultaneous boom in all industrialized economies. There were also devaluations of the dollar which were responses to historical trends in costs and interest rates in the United States and abroad. Interest costs increased as the Federal Reserve attempted to halt the inflation by tightening the money supply.

These special circumstances were responsible for beginning the inflation the United States now experiences. Price increases were caused only in part by excess demand for output in the United States; excess demand worldwide contributed heavily to the pressure on prices. This combination of events would have caused an acceleration in the rate of inflation in the United States even if domestic demand had been restricted by monetary and fiscal policies. Even if these policies had restricted demand sufficiently to increase the rate of unemployment to 6 percent, rather than the 5 percent rate that prevailed, the special problem that caused food and fuel prices to rise would have increased the general price level. The size of the total increase would, however, have been somewhat smaller.

In 1974, the inflation rate began to spread from food, energy, imports, and mortgage interest rates to other sectors of the economy. Price controls were eliminated in April and wages started up. In the first 6 months of 1974, the CPI increased at a rate of 12.5 percent. The special factors still were causing an abnormal share of this inflation—particularly energy prices which increased at a rate of 43 percent—but the prices of the 60 percent of the index which had been stable until 1974 increased at a rate of 11.6 percent in the first 6 months of that year. The inflation which began in special, isolated sectors had begun to spread to the rest of the economy. By the last half of 1974, inflationary pressures were widespread. In the four special sectors, the inflation rate had fallen below 14 percent, while in the rest of the economy it was near 10 percent.

In the first half of 1975, the special factors had a lower rate of inflation than the rest of the economy. The total CPI increased at a rate of only 6.8 percent despite an inflation rate of 7.3 percent in all sectors except the four special ones. The data for all periods are presented in the table.

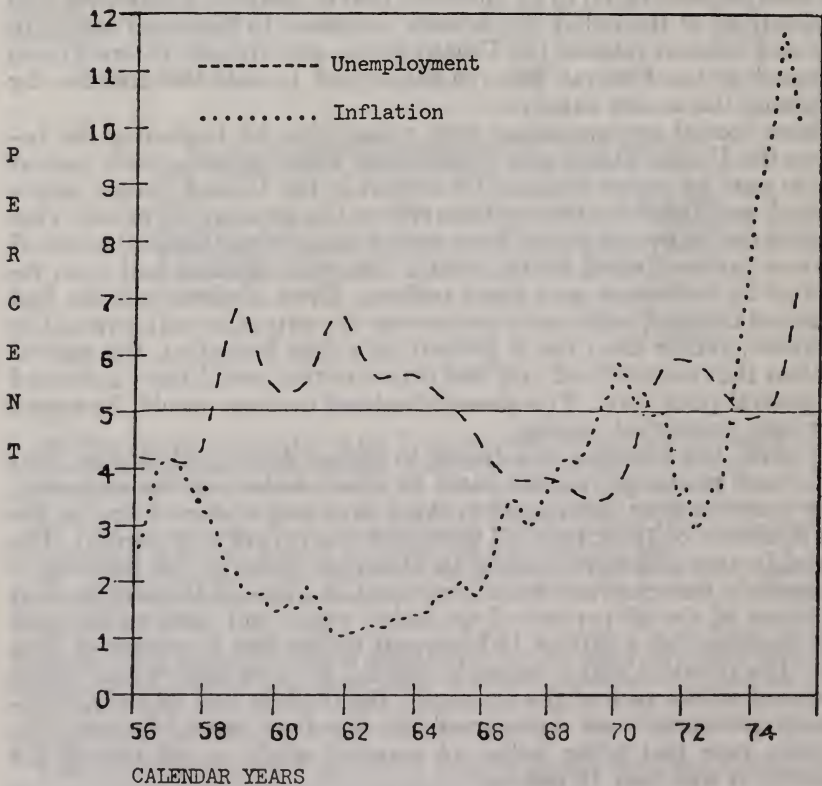
INFLATION AND UNEMPLOYMENT

The extremely unbalanced nature of the inflation, particularly in its early stages, supports the conclusion that the inflation was due primarily to a few special factors. Inflation caused by excess economic activity tends to proceed in a much more balanced way across the whole range of goods and services. While the existence of price controls may have distorted normal relationships, there simply was no serious inflation in 1973 except in those sectors which had special problems.

Further evidence that the inflation was not due to excess aggregate demand is found in the relation between inflation and the level of utilization of capacity of the economy.

The following chart presents the history of inflation and unemployment since 1954. Note that until 1973, the unemployment rate and the inflation rate generally moved in opposite directions. Over that period,

HISTORICAL RELATION BETWEEN INFLATION AND UNEMPLOYMENT



Inflation -- 12 month moving average of CPI.

Unemployment -- 12 month moving average of the unemployment rate.

one could make reasonably good predictions of how the inflation rate would change simply by noting the unemployment rate. When the unemployment rate was below the 4.5 to 5 percent range, inflation accelerated; when it was above that range, inflation fell.

This data supports the conclusion that in the 2 decades before late 1973, inflation was caused by excess demand. When the economy expanded, the unemployment rate fell and the inflation rate increased. Since late 1973, a different relationship has emerged. Inflation appeared when the unemployment rate was not excessively low, and it continued to accelerate even when unemployment was quite high. Instead of excess purchasing power driving prices up, in the recent period the higher prices have reduced real purchasing power and forced cutbacks in production.

The price controls of 1973-74 offer an alternative explanation of the unbalanced nature of the inflation, since it was worst in those sectors which were uncontrolled. But if the inflation had been due to excess demand, one would have expected the unemployment rate to fall when the inflation rate increased. The fact that since mid-1973 they both increased at the same time supports the conclusion that the increased rate of inflation since that time has been due to cost factors rather than to demand.

SUMMARY TO APPENDIX

Just as these higher prices caused production to fall, lower prices brought about by direct government action can cause production to increase. While there remains a tradeoff between inflation and unemployment, in the sense that general economic activity affects them in opposite directions, policies are available which can reduce both of these evils at the same time.

The unbalanced nature of the recent inflation suggests that it was caused by special cost factors rather than by excess demand. This conclusion is also supported by the fact that this inflation was accompanied by high rather than low unemployment rates. Since reduction in those prices that are directly controlled by government should have the opposite effect on the economy to that caused by the OPEC price increase, it should be expected that prices and unemployment can be reduced at the same time through a policy of direct reductions in costs.

EMPLOYMENT

(25)

Preface

This paper was prepared to provide background for the deliberations of the Senate Budget Committee prior to their markup of the First Concurrent Resolution on the Budget for Fiscal Year 1977.

The report was prepared by Arnold Packer, Anthony Carnevale, Charles McQuillen, and Martin Asher of the Senate Budget Committee staff and by David Mundel and Alan Fein of the Congressional Budget Office.

EDMUND S. MUSKIE,
Chairman.

EMPLOYMENT

I. The Problem and Alternative Solutions

A. THE PROBLEM

1976 AND 1977

More Americans either lost or failed to find opportunities to earn livings commensurate with their ability in 1975 than in any other year since the depression of the 1930's.

In the first quarter of the bicentennial year 7.6 percent of the formally defined labor force was unemployed, about 7.2 million individuals. Another 0.9 million people has dropped out of the formal labor force because they failed to find work and gave up the search. Although there has been substantial improvement since the 8.9 percent unemployment recorded last spring, the unemployment at the end of this year will still exceed that recorded in the depth of previous post-war recessions.

The unemployment rate for this year will be determined by the fiscal and monetary policy set for fiscal 1976 and the Transition Quarter. Most forecasters believe that these policies will bring unemployment down by one-half percentage point more (to 7.0 percent) during the course of this year. Most forecasters also predict that the unemployment rate will decline moderately again during fiscal 1977 if Federal expenditures and revenues are maintained at the current policy level.

THE LONGER-TERM FUTURE

Under any credible set of economic assumptions, unemployment will be at unusually high levels for at least several years beyond 1977.

The Congressional Budget Office (CBO) has developed two economic paths upon which to base a 5-year budget projection.¹ The "slow-growth" path is more optimistic than some private forecasts and provides for sustained growth rates that equal the best of the postwar years. The "fast-growth" path probably comes close to the best that could be achieved under the most favorable conditions. The number unemployed under these two outcomes are shown below:

Table 10.—UNEMPLOYMENT AND EMPLOYMENT UNDER TWO ECONOMIC GROWTH PATHS

		[In millions]					
CBO path		1975	1976	1977	1978	1979	1980
Number unemployed:							
Slow growth (path B)-----		7.7	7.2	7.2	7.0	6.7	6.4
Fast growth (path A)-----		7.7	7.0	6.2	5.4	4.9	4.7
Number employed:							
Slow growth (path B)-----		84.8	87.0	89.2	91.7	94.0	96.2
Fast growth (path A)-----		84.8	87.3	90.6	93.8	96.6	99.0

¹ See *Five-Year Projections Fiscal Years 1977-81*, Congressional Budget Office, January 26, 1976.

B. GOALS

The ideal solution to the unemployment problem is to create an economic climate in which all Americans of working age can realize their full potential without creating inflationary labor shortages. Given the present state of the economy, this ideal solution cannot be fully achieved. A more realistic set of goals would be to—

- (1) provide most individuals with an opportunity to use their skills in a manner that would provide adequate incomes and reasonable job satisfaction without creating inflationary labor shortages;
- (2) establish education and training programs that could develop and maintain the skills required in the labor markets;
- (3) enforce anti-discrimination laws and improve information and placement services so that there is a better match between available opportunities and available human resources; and
- (4) provide, without reducing the incentive to seek employment, adequate income maintenance so that those who cannot find appropriate employment still can maintain an adequate standard of living.

It is difficult to translate these broad goals into specific numerical unemployment rate targets. Most observers believe that an unemployment rate of 4.0 to 5.5 percent would satisfy the first goal, given the current labor market structure. However, even the high 5.5 percent unemployment rate probably cannot be achieved before 1978 and may not be achieved by 1981 if the slow growth path is chosen. Therefore, a fifth goal must be added for the next few years, to be achieved by—

- (5) structuring Federal budgets in a way that will provide the appropriate response to the abnormally high unemployment that appears inevitable while enhancing the possibility of meeting the first four goals as the economy is restored to full employment.

C. BASIC APPROACHES AND DECISIONS

A diversity of approaches to alleviate unemployment undoubtedly will be used during the next 5 years. The basic policy question is not which approach to use but rather what mix provides the best overall strategy.

(1) MACROECONOMIC

The most important approach, and the one without which no approach can succeed in the long run, is to set general fiscal and monetary policies that will increase economic demand in the private sector. *The Budget Committee must recommend overall spending and revenue targets to the full Senate on April 15. The Committee should also indicate its economic goals and expectations to the Federal Reserve Board.*

(2) ENHANCED EMPLOYABILITY

Training, education, placement services, day care programs, and other programs to improve the match between skills and opportunities will be important elements of the solution. Other experimental approaches such as wage subsidies might be considered. *The Committee must indicate its view on the President's proposed accelerated depreciation on investment in high unemployment areas.*

(3) INCOME MAINTENANCE

Unemployment compensation, food stamps, welfare assistance, and other similar programs can help maintain adequate standards of living on a temporary basis for the unemployed. *The Committee must decide whether to recommend extension of the Federal Supplemental Benefits (FSB) and Special Unemployment Assistance (SUA).*

(4) DIRECT EMPLOYMENT

Anticyclical revenue sharing, federally financed public works projects, and/or other public employment programs can directly increase the number of available jobs in the United States. *The Committee must decide whether to include funds for these programs in the First Concurrent Resolution (FCR).*

Not only are all four of these approaches probably necessary, they must be integrated as part of a total national effort. Funds spent for public works, training, or income maintenance not only provide direct assistance to individuals, they provide additional fiscal stimulus for the economy as a whole unless their effect is offset by tax increases or reductions in spending for other purposes. The Committee must also bear in mind the inflationary risk of an overly stimulative budget and the potential that inflation may have for thwarting the economic recovery.

II. Growth: How Fast?

THE MAJOR CHOICE

The most important decision Congress must make about unemployment is whether to adopt fiscal and monetary policies that will produce fast growth of the economy over the next 5 years.

Restoring a healthy economy clearly is the most desirable way to solve the unemployment problem. The most durable and socially acceptable employment is generated either in response to consumer demand for goods and services or to citizen demand for public services which the citizens are willing to support with tax dollars. These positions, derived from economic demand, offer the best chance for entry into career ladders leading to permanent jobs at adequate pay.

The two economic growth paths charted by the CBO would produce very different employment outcomes as shown in Table 1.

The CBO slow growth path would leave 1.6 million more unemployed in 1978 or 6.3 million more person-years of unemployment over the 1976-80 period than would the fast growth path. Counting discouraged workers makes the difference even more dramatic. *The difference in the number employed would be 2.1 million in 1978 or 9.2 million person-years of employment over the 5-year period.* Moreover, even this understates the difference in employment experience. Fast growth undoubtedly would produce higher productivity and larger real wage gains. Promotion, advancement, and other signs of career advancement would be more prevalent with fast growth as would profits and business investments.

The major danger of faster growth is that it could be more inflationary. Many (but not all) econometric studies indicate that inflation depends on how low unemployment gets, not how fast it gets there.

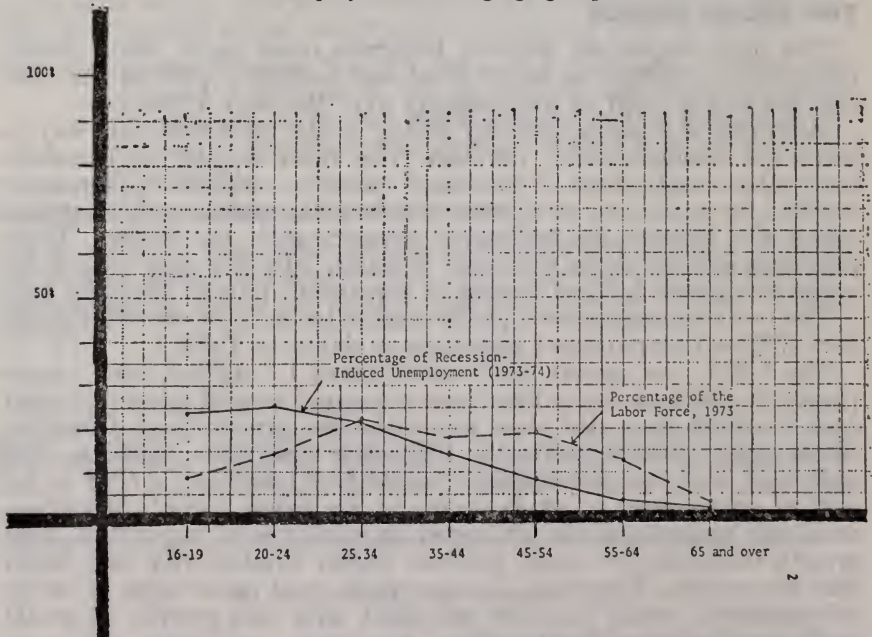
If this is correct, inflation would be the same after unemployment falls to 4.5 percent whether this goal were achieved in 1980 or 1985. The price *level* would be, however, higher under the faster growth path because inflation would be higher in earlier years. Moreover, the possibility that there are "speed limits", beyond which inflation accelerates independently of the level of unemployment, cannot be ignored. The CBO annual report contains a discussion of the alternative paths, the fiscal and monetary stimulus required for each, and the inflationary risks.

UNEMPLOYMENT: THE MANY PROBLEMS

The United States has not just one unemployment problem but many. And the right mix of solutions to unemployment depends upon *who* is unemployed, and *why*.

Younger workers, for example, have relatively high unemployment rates even when jobs are plentiful and suffer disproportionately from recession-induced unemployment.¹ Although workers between the ages of 16 and 24 account for only about 20 percent of the civilian labor force, they accounted for about 48 percent of the recession-induced unemployment between 1973 and 1974. As shown in Table 2, fast growth would provide 400 thousand more jobs for teenagers in 1978 than would a slow growth path.

FIGURE 1.—Distribution of the civilian labor force and recession-induced unemployment among age groups



Source: U.S. Department of Labor, Bureau of Labor Statistics.

¹ Recession-induced unemployment is calculated by subtracting the unemployment during periods of low overall unemployment from that during periods of high overall unemployment.

Nonwhite workers of all sexes and all ages have higher unemployment rates than do their white counterparts during periods of both low and high unemployment. When the recent recession began, the unemployment rate among nonwhite workers was 4.3 percentage points higher than that among white workers. It was 6.0 percentage points higher at the depth of the recession and 6.2 in the first quarter of 1976, as shown in Table 3. Fast growth would mean 350,000 more jobs for minorities in 1978 (Table 2).

There is a direct correlation between levels of education and unemployment. In March 1975, the unemployment rate for college graduates was 2.9 percent while the rate for workers who had not graduated from high school was 13.8 percent. The rate for all workers was 9.2 percent.³ Less educated workers also account for disproportionately high shares of recession-induced unemployment. Workers in manufacturing (for both durable and nondurable goods) and construction account for disproportionately high shares of recession-induced unemployment.⁴

Table 2.—DIFFERENCE IN EMPLOYMENT BY AGE, SEX, AND RACE BY ACHIEVING 6 PERCENT RATHER THAN 5 PERCENT AVERAGE REAL OUTPUT GROWTH¹

[Thousands of persons]					
	1976	1977	1978	1979	1980
Total-----	353	1, 303	2, 113	2, 592	2, 809
Males:					
(16-19):					
Nonwhite-----	10. 7	35. 8	52. 1	55. 8	51. 7
White-----	28. 3	97. 9	153. 8	178. 3	177. 4
(20-24):					
Nonwhite-----	10. 7	36. 3	51. 4	54. 8	51. 8
White-----	50. 0	183. 2	282. 1	314. 9	309. 2
(25-59):					
Nonwhite-----	13. 8	62. 2	115. 2	150. 2	170. 1
White-----	96. 2	318. 3	465. 6	524. 8	528. 4
(60 and over):					
Nonwhite-----	1. 7	5. 4	8. 8	12. 0	14. 1
White-----	-6. 4	-24. 0	-29. 6	5. 0	66. 0
Females:					
(16-19):					
Nonwhite-----	6. 7	26. 4	45. 4	56. 3	60. 7
White-----	27. 2	95. 8	153. 7	182. 9	187. 3
(20-24):					
Nonwhite-----	3. 0	16. 7	31. 8	34. 0	26. 7
White-----	29. 6	102. 6	143. 7	141. 8	116. 4
(25-59):					
Nonwhite-----	7. 0	34. 5	72. 8	106. 9	132. 4
White-----	79. 6	379. 0	693. 4	859. 9	904. 9
(60 and over):					
Nonwhite-----	- . 8	-3. 7	-6. 9	-7. 0	-10. 5
White-----	-4. 1	-63. 9	-120. 6	-76. 9	22. 6

¹ From unpublished Urban Institute data.

³ *Monthly Labor Review*, February 1976. Not seasonally adjusted.

⁴ Derived from Manpower Report of the President, April 1975.

**Table 3.—UNEMPLOYMENT RATES BY RACE, SEX, AND AGE
DURING THE CURRENT RECESSION ¹**

Demographic group	1973:IV	Unemployment rate	
		1975:II	1976:I
All.....	4.8	8.7	7.6
Adult males.....	3.1	7.0	5.7
White.....	2.9	6.4	5.1
Nonwhite ²	5.5	11.8	10.9
Gap (nonwhite-white).....	2.6	5.4	5.8
Adult females.....	4.8	8.4	7.4
White.....	4.3	7.9	6.8
Nonwhite ²	8.1	11.9	11.1
Gap (nonwhite-white).....	3.8	4.0	4.3
Teenagers (16-19).....	14.6	10.1	19.4
White.....	12.9	18.1	17.5
Nonwhite ²	28.5	37.2	35.2
Gap (nonwhite-white).....	15.6	19.1	17.7
All white.....	4.3	8.1	6.9
All nonwhite.....	8.6	14.1	13.1
Gap (nonwhite-white).....	4.3	6.0	6.2

¹ Seasonally adjusted quarterly rates: U.S. Department of Labor, Bureau of Labor Statistics.

² Negro and other races of whom 89 percent are Negro. See *Employment and Earnings*: October 1975, U.S. Department of Labor, Bureau of Labor Statistics, p. 161.

Unemployment among household heads has increased dramatically during the current recession. In January 1974, 1,533,000 household heads were unemployed. By November 1975, this number had grown to 2,980,000. Over a similar time period, the unemployment rate for household heads increased from 2.9 to 5.6 percent.⁵ (See Figures 2 and 3).

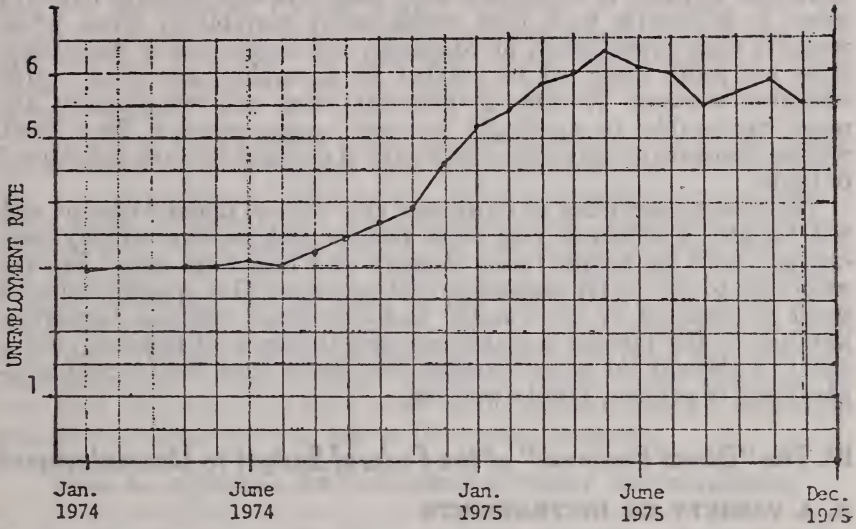
As to the *why* of unemployment, it can be caused by a number of factors, including—

- cyclical inadequacies of demand that cause short-term layoffs or furloughs;
- lags between the time workers leave one job and the time they find others;
- structural imbalances between the skill levels of available workers and the skill requirements of employers;
- disparities between the geographic locations of jobs and the homes of workers; and
- seasonal imbalances between numbers of jobs and numbers of workers.

Taking the who and why of unemployment together, it can be seen that not only does the unemployment rate vary among population groups, its causes vary among groups. The chronically high unemployment rates of teenagers is due in part to their lack of job skills and work experience, in part to the limited attractiveness and con-

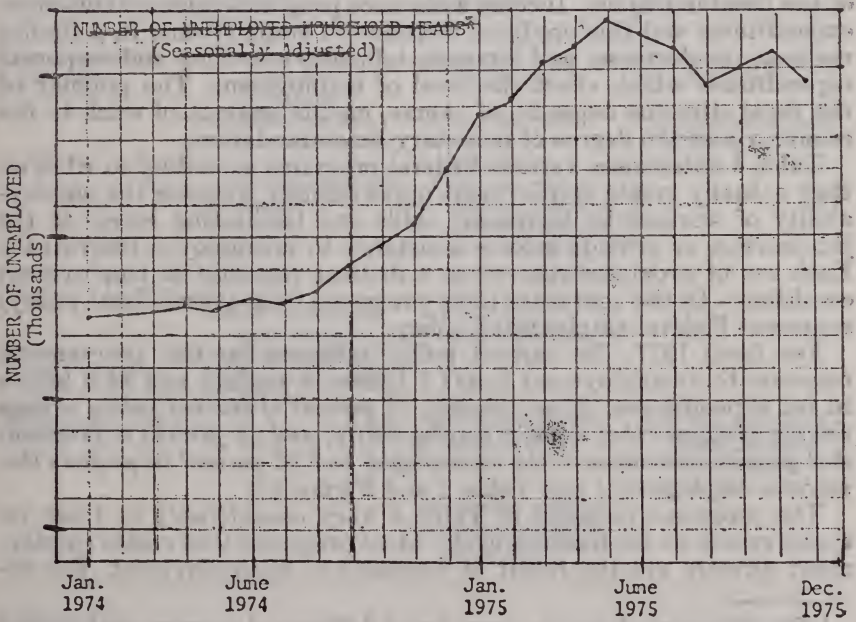
⁵ Unpublished Bureau of Labor Statistics data.

FIGURE 2.—Unemployment rates of household heads
(seasonally adjusted) ¹



¹ Unpublished BLS statistics.

FIGURE 3.—Number of unemployed household heads
(seasonally adjusted)



Source: BLS unpublished statistics.

stancy of the jobs to which they have access, and in part to their more limited need for income. The higher unemployment rates of less-educated workers is associated with their disproportionate employment in industries with high employment variability. Even when workers with lower levels of education are within stable industries, they are more likely to be subject to unemployment than better educated workers. Workers in manufacturing and construction are more vulnerable to cyclically induced unemployment than most workers because of the cyclical volatility of demand for their industries' outputs.

The uneven incidence of structural and cyclical unemployment and the variety of economic and social factors that cause unemployment create a need for a wide range of short- and long-term direct Federal responses to particular unemployment problems. One specific response must be directed to the training and experience needs of teenagers, another to the income maintenance requirements of families, and a third to prevent the social damage that arises from long-term unemployment of primary family workers.

III. The "Direct Response" of the Federal Budget to Unemployment

A. A VARIETY OF INSTRUMENTS

All Federal expenditure and revenue policies affect the levels of employment and unemployment. Defense and nondefense purchases of goods and services result in jobs. And as long as there are unemployed resources, these jobs result, in turn, in more jobs through the effects of the fiscal multiplier. Income assistance programs increase consumer expenditures and this produces increases in employment. In a similar manner, tax decreases and increases influence consumer and corporate expenditures which affect the level of employment. The potency of the fiscal stimulus depends, of course, on the amount of slack in the economy and the degree of monetary accommodation.

Table 4 categorizes various Federal programs according to whether they actually create employment opportunities, increase the employability of workers by increasing skills and facilitating access to the job market, or provide income assistance to unemployed individuals. Each set of programs represents a distinct response to employment conditions. In the aggregate these programs (and overall fiscal policy) represent Federal employment policy.

For fiscal 1977, the current policy estimate for this programatic response to unemployment is \$41.7 billion in outlays and \$4.9 billion in tax expenditures. *Approximately 43 percent of current policy outlays finance programs that improve employability; and 45 percent to programs that provide assistance to the unemployed and 12 percent to projects that increase employment.*¹ (see Table 5 and Figure 4.).

The programs included in Table 4 vary considerably in their responsiveness to the business cycle. Most programs that create employment directly are the result of increases in unemployment. For ex-

¹ The allocation is based on a very broad definition of programs that increase employability; it includes Federal aid to elementary, secondary, and higher education (excluding research and general education aid) as well as manpower training and vocational rehabilitation.

ample, the Congress passed temporary stimulus measures such as Temporary Employment Assistance, Countercyclical Revenue Sharing, and Accelerated Public Works. Virtually all programs that are intended to improve employability are less sensitive to changes in employment. Spending for programs in the third category, those that provide income for the unemployed, vary directly with changes in employment.

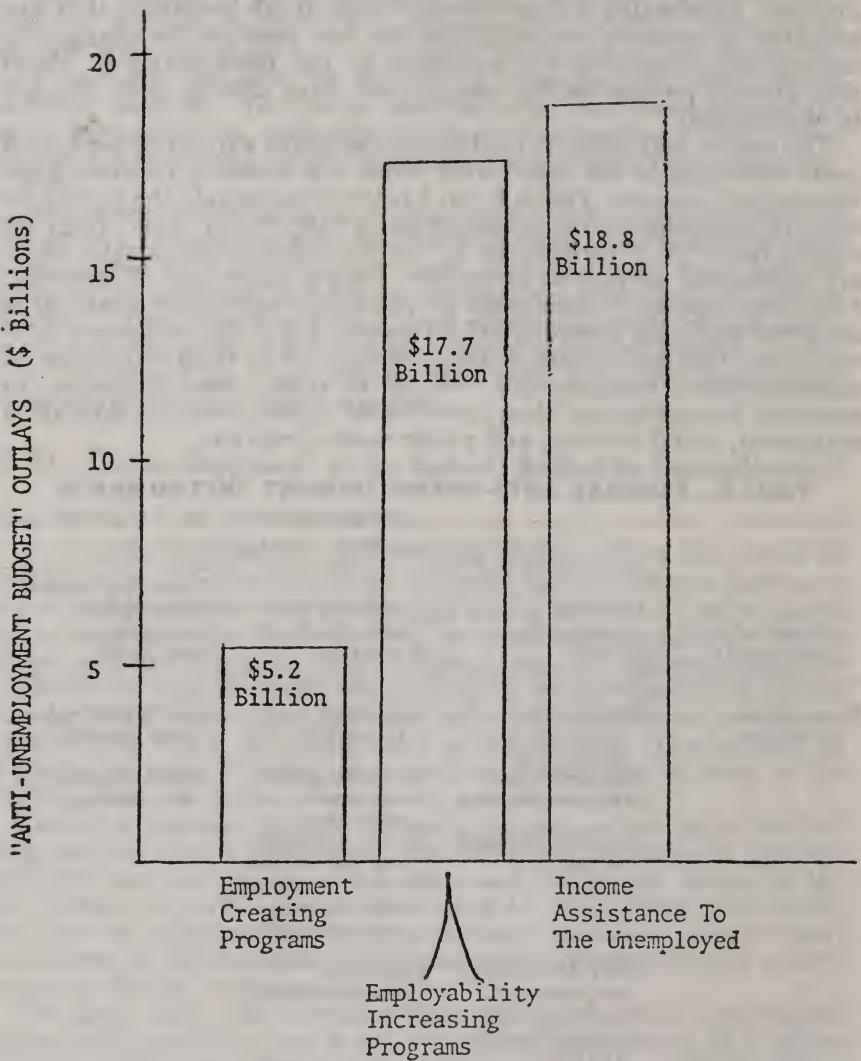
The cost of employment-related programs will vary over the next 5 years according to the speed with which the economy recovers from the current recession. Tables 6 and 7 below demonstrate the impact on costs in the unemployment budget under "slow" and "fast" recovery assumptions.² As a comparison of the two tables demonstrates there are substantial savings to be realized from a faster rate of recovery. *Cumulative savings realized when the fast growth alternative (Path A) is compared with slow growth (Path B) come to \$38.5 billion between 1976 and 1981.* The lion's share of these savings result from reductions in unemployment compensation, which is much more sensitive to economic improvements than more stable expenditures for education manpower, social services, and public works programs.

Table 4.—FEDERAL ANTI-UNEMPLOYMENT INSTRUMENTS

Classes of instruments	Programs and policies aimed primarily at—		
	Creating employment directly	Increasing the "employability" of workers	Providing income assistance to unemployed individuals
Expenditure programs.	Temporary employment assistance. Countercyclical revenue sharing. Accelerated public works. Older Americans employment. Summer youth ---- Job opportunities (EDA).	Education assistance. Comprehensive manpower assistance. Manpower training and service veterans education, training, and rehabilitation. Vocational rehabilitation.	Unemployment compensation. Trade adjustment assistance.
Tax policies-----		Tax subsidies for education. WIN tax credits--- Tax deductions for child care.	Tax exemption of unemployment compensation benefits.

² *Five-Year Budget Projections, Fiscal 1977-1981*, Congressional Budget Office, January 26, 1976, p. 4.

FIGURE 4.—Distribution of the anti-unemployment budget outlays (fiscal year 1977 current service base) 5 percent growth path



**Table 5.—THE FEDERAL DIRECT RESPONSE TO UNEMPLOYMENT
(FISCAL YEAR 1977 CURRENT SERVICES) ¹**

[Billions of dollars]

Classes of instruments	Programs and policies aimed primarily at—		
	Creating employment directly	Increasing the "employability" of workers	Providing income assistance to unemployed individuals
Expenditure programs:			
Temporary employment assistance ²	2.8	-----	-----
Countercyclical revenue sharing ³	.8	-----	-----
Accelerated public works ³	NA	-----	-----
Older Americans employment	.1	-----	-----
Job opportunities (EDA) ²	.5	-----	-----
Summer youth	.5	-----	-----
Higher education	-----	2.8	-----
Elementary, secondary, and vocational education	-----	5.4	-----
Comprehensive manpower assistance ²	.6	2.3	-----
Manpower training and services ²	-----	1.5	-----
Veterans education, training, and rehabilitation ²	-----	4.9	-----
Vocational rehabilitation	-----	.9	-----
Unemployment compensation ²	-----	-----	18.8
Total expenditure program	5.2	17.7	18.8
Tax policies: ⁴			
Win tax credits	-----	(*)	-----
Tax deduction for child care	-----	.4	-----
Tax exemption for education	-----	1.7	-----
Tax exemption for unemployment compensation	-----	-----	2.8
Total tax policies	-----	2.1	2.8

¹ At CBO estimate of economy (Path B).² CBO estimate.³ Included in Second Concurrent Resolution but not enacted.⁴ Derived from JCIRT (c).

*Less than \$50,000,000.

NA—Not available.

NOTE: Numbers may not add to totals due to rounding.

Table 6.—“DIRECT RESPONSE” BUDGET (PATH A)

[Billions of dollars]

	Fiscal year—						Cumulative, 1977-81
	1976 (est)	1977	1978	1979	1980	1981	
Creating employment directly ¹	5.1	4.5	2.8	2.2	2.0	2.0	13.5
Increasing the employability of workers ² -----	18.3	17.8	18.6	19.5	20.3	21.3	97.3
Providing income assistance to unemployed individuals ³	19.8	15.3	11.0	9.5	8.9	9.4	54.1

¹ Includes funds from manpower programs (pt. 504) for all years, and smaller amounts from countercyclical revenue sharing (pt. 450) for fiscal year 1976-77 and from accelerated public works (pt. 450) for fiscal year 1976 and the Transition Quarter as specified in the U.S. Congress Second Concurrent Resolution on the Budget, fiscal year 1976.

² Includes moneys from education (501, 502), manpower (504), vocational rehabilitation (506), and veterans education, training, and rehabilitation (702).

³ Unemployment compensation (603) consisting of regular and extended benefits, Federal supplemental benefits, and special unemployment assistance.

Table 7.—“DIRECT RESPONSE” BUDGET (PATH B)

[Billions of Dollars]

	Fiscal year—						Cumulative 1977-81
	1976 (est)	1977	1978	1979	1980	1981	
Creating employment directly ¹	5.1	5.2	4.3	3.9	3.6	3.3	20.3
Increasing the employability of workers ² -----	18.3	17.7	18.3	19.1	19.7	20.3	95.1
Providing income assistance to unemployed individuals ³	19.8	18.8	18.8	18.2	16.9	15.3	88.0

¹ Includes funds from manpower programs (pt. 504) for all years, and smaller amounts from countercyclical revenue sharing (pt. 450) for fiscal year 1976-77 and from accelerated public works (pt. 450) for fiscal year 1976 and the Transition Quarter as specified in the U.S. Congress Second Concurrent Resolution on the Budget, fiscal year 1976.

² Includes moneys from education (501, 506), manpower (504), vocational rehabilitation (506), and veterans education, training, and rehabilitation (702).

³ Unemployment compensation (603) consisting of regular and extended benefits, Federal supplemental benefits, and special unemployment assistance.

B. ENHANCED EMPLOYABILITY AND INCENTIVES

Many current and proposed responses to unemployment involve creating incentives and making information available to workers and firms. Some create incentives for employers to hire workers while others enhance the incentives of workers to find jobs.

If there is an absolute limit to the number of jobs that can be made available at any given time, then enhancing the employability of one individual may only mean that he or she will replace another individual in a job without producing any net reduction in unemployment.³ Even in periods of high unemployment, however, some jobs go unfilled. When, for example, some unemployed do not have necessary skills or when qualified unemployed persons are unaware of openings or live a substantial distance from available jobs, unemployment and unfilled openings can coexist.

The matching of openings to skills has become increasingly difficult during the last 10 years because of changes in the composition of the labor force. In particular, the large increase in the number of working wives and teenagers who typically have higher unemployment rates than household heads has made achievement of 4 or even 5 percent unemployment, without creating severe inflationary pressures, more difficult. The demographic change of the last 10 years is shown in Table 8.

By 1980, however, those born at the beginning of the post-World War II baby boom (1947) will be 33 while those born at the end (1957) will be 23 years old. Thus, the teenagers of 1975 will be ready to take full-time career jobs in 1980 if positions are available and if education and training programs have been effective.

Table 8.—DEMOGRAPHIC CHANGES IN THE LABOR FORCE AND UNEMPLOYMENT ROLLS

[Percent]

	1965	1970	1975
Share of the labor force:			
Household heads.....	59.4	58.8	57.6
Married men with wives present.....	48.6	46.5	43.3
Female household heads.....	NA	7.9	8.9
Teenagers (16-19).....	7.8	8.8	9.5
Women 20 and over.....	31.3	34.2	35.6
Share of the unemployed:			
Household heads.....	36.4	34.7	39.1
Married men with wives present.....	25.5	24.5	26.1
Female household heads.....	NA	6.9	8.0
Teenagers (16-19).....	25.3	27.0	22.4
Women 20 and over.....	30.6	32.7	33.8

NA—Not available.

³ In fact, measured unemployment may increase if training or the availability of day-care facilities increases the labor force without increasing the number of jobs.

Teenagers may become a smaller part of the labor force but the increase in female participation is expected to continue. It is difficult to tell whether the effect of the growing number of women who are permanently in the labor force—and therefore should have unemployment rates similar to men in comparable circumstances—will offset the effect of the women who are entering or reentering the labor force after an extended period of absence.

It is clear that the employment experience of secondary workers in a family is different from that of breadwinners. Many teenagers seek employment only during school vacations. Some mothers with school-age children seek employment only when schools are in session. The needs and skills of these groups must be matched with job opportunities if the overall unemployment rate is to be reduced to the levels of the previous generation.

EDUCATION AND TRAINING

Only if education and training programs foster skills that are in short supply will there be a net addition to employment. Manpower training programs are not likely to be successful when unemployment is very high. As unemployment recedes, however, the need to match skills and jobs will increase. Otherwise, both unemployment and inflation will be higher than necessary. This suggests that it would be worthwhile to include training as a component of any public employment program and to develop better training and information support for teenagers.

The next few years could provide an opportunity to upgrade the skills of the labor force *if* effective training programs can be mounted and *if* economic recovery can be counted on to provide jobs for those who have completed training.

Although 43 percent of the jobs-oriented portion of the Federal budget is invested in training and rehabilitation for persons who cannot find work, no comprehensive review ever has been made of the effectiveness of those programs.

Some very general conclusions about training and rehabilitation programs were reached in a 1975 review of 252 fragmented studies of various individual programs.⁴

The review supports only the broadest sorts of conclusions about the effectiveness of programs: (a) they have enhanced the earning power of trainees modestly; (b) they have not solved all the problems of people who have been enrolled in the programs; and (c) they cannot be judged failures. Because of differing assumptions among the studies, different data bases and differing methods of review, the conclusions are only tentative. A better evaluation is unlikely until there are experiments that compare the work experience of training program graduates with control groups of individuals with similar backgrounds who did not enroll in training programs.

The best-designed study available for review concentrated on 1964 graduates of training programs under the Manpower Development and Training Act.⁵

⁴ Perry, Charles R., et al., *The Impact of Government Manpower Programs* (The Wharton School, 1975).

⁵ Orley Ashenfelter, "Program Report on the Development of Continuous Performance Information on the Impact of the Manpower Development Act", Technical Analysis Paper No. 12A, U.S. Department of Labor, October 1973.

On the basis of his review, the author concluded that:

- (1) The training program increased the average annual earnings of graduates by \$377 between 1965 and 1969.
- (2) Black males benefited more from the program than did white males, enhancing their earnings by an average \$350 a year contrasted with an average increase of \$250 a year for white males.
- (3) Both black and white females benefited most from the program, increasing their earning power by an average \$550 per year.

Other research establishes some general comparisons on cost effectiveness among some programs. Under Title I of the Comprehensive Education and Training Act, for example, earnings of participants were increased by \$400 to \$800 per year at a program cost in 1975 of \$1,700 per enrollment; a relatively good return on the investment. On the other hand, Job Corps programs under Title IV of the Act increased annual earnings of individuals by only \$200 to \$400 at a cost-per-person of \$3,421.

WAGE SUBSIDIES

Training enhances the value of a worker to a firm. Another way to provide an employment incentive is to lower the cost of labor to an employer. Serious consideration has been given to two proposals of this type. One is reduction in the minimum wage paid to teenagers (sometimes coupled with a training requirement). Another is to provide a wage subsidy.

If there is a limited number of jobs, these incentives will only determine who will find work, not how many people will be employed. However, when there are vacant jobs such as delivering merchandise a subsidy or minimum rate reduction could increase employment.

One possibility would be a pilot program of limited wage subsidies for teenagers to try to bring down the very high unemployment rate in that group. The annual wage of a full-time employee receiving the minimum wage is now \$4,600. The employer's payroll tax contribution for social security and unemployment compensation is now almost 9 percent. In addition, other fringe benefits might cost hundreds of dollars more. A subsidy of \$500 for a year to cover these fringe benefits would reduce the effective wage by 10 percent. If the subsidy were paid for the first year of employment for newly hired 16 to 19 year olds, the cost might be \$0.5 billion. Another approach would be to forgo both employee and employer contributions to social security for the first year of full-time teenage employment. The employer's cost would then be reduced by approximately \$500 while the teenager would receive the same take home pay.

It is difficult to estimate how much additional employment this small subsidy would produce. One drawback to the concept is that there may be an incentive for an employer to hire a teenager and fire him 1 year later. If the employer then hired a new teenager, he would once again be eligible for a \$500 savings, whereas if he retained the old teenager, his savings would lapse after the first year. However, it would tend to help the teenager get his first job and it is an approach that merits consideration.

Another approach is a \$200 per-person-per-month tax credit available to employers who increase their work force. An employer hiring labor at an average wage of \$5 per hour would then save \$1.25 an hour in unit labor costs. The staff can find no evidence that such a system has been tested in the United States, even on a pilot basis. But, in theory, the subsidy should give employers an incentive to hire. In order to limit the revenue loss, the credit could be phased out over 18 months and the credit could apply only to employees in excess of the average work force prior to the introduction of a tax credit.

In such a system, the direct costs of Federal support to the unemployed would be reduced and the psychological costs of unemployment to many workers and their families could be eliminated. However, the lost revenues could be substantial.

A third alternative is to provide a subsidy for creating a shorter work-week, thereby spreading the burden of unemployment more widely. In some European countries, compensation is paid to workers who work 4 days a week. Other approaches to increase labor force participation or ease the transition from school to work can also be considered. It is important to recognize, however, that these will not be very effective unless the demand for labor is increased.

C. INCOME MAINTENANCE FOR THE EMPLOYABLE

There are two types of income maintenance programs other than retirement and disability programs. One is unemployment compensation, a temporary payment based not on need but on previous work experience and earnings. The second is welfare—food stamps, AFDC, Medicaid, and other semi-permanent income maintenance programs—based mainly on need, not on employment experience. Some families or individuals may be eligible for both types of assistance. The government may spend \$199 to \$231 billion for these programs over the next 5 years. (See Table 9.)

Spending for non-retirement income transfer programs fluctuates during the business cycle, partially offsetting swings in economic activity and individual income. HEW estimates 35 percent more beneficiaries and (because the benefit per person for some programs increases with reduced income) a 71-percent higher cost for cyclically sensitive transfer programs in the fourth quarter of 1976 because of the recession.⁶

Several major concerns have been voiced with regard to these programs.

- Is the patchwork of income support programs adequate to provide a decent standard of living for those who cannot work?
- Do the programs provide equal treatment to those in similar circumstances?

- Does income maintenance create disincentives to work?

The circumstances of 1975 added one further question:

- can State and local governments in areas of high unemployment maintain the fiscal capacity to shoulder their share of this income maintenance burden?

⁶ HEW, Technical Analysis Paper No. 7, "The Cyclical Behavior of Income Transfer Programs: A Case Study of the Current Recession."

Table 9.—OUTLAYS FROM INCOME SUPPORT PROGRAMS¹ FOR THE EMPLOYABLE,² 1976-1981

[In billions of dollars]

	Estimate						Total
	1976	1977	1978	1979	1980	1981	1977-81
PATH A (FAST GROWTH)							
Unemployment compensation:							
Supplemental benefits-----	3.5	2.5	0.6	0.3	0.2	0.2	3.8
Regular programs-----	16.4	13.8	10.8	9.6	9.2	9.7	53.1
Public assistance (AFDC)-----	5.8	6.4	7.1	7.6	8.3	8.9	38.3
Food stamps-----	5.9	6.5	7.4	8.3	9.6	10.9	42.7
Child nutrition and other food-----	2.7	3.3	3.5	3.8	4.1	4.4	25.1
Housing assistance-----	2.6	3.1	3.9	5.1	6.6	8.1	26.8
Medicaid ³ -----	2.1	2.4	2.6	3.0	3.3	3.6	17.0
Subtotal, Path A-----	39.0	38.0	35.9	37.7	41.3	45.8	198.7
PATH B (SLOW GROWTH)							
Unemployment compensation:							
Supplemental benefits-----	16.4	16.1	16.5	16.1	15.8	15.0	79.5
Regular programs-----	3.5	3.1	2.9	2.7	1.7	0.8	11.2
Public assistance (AFDC)-----	5.8	6.5	7.0	7.5	8.0	8.6	37.6
Food stamps-----	5.9	6.7	7.5	8.5	9.4	10.4	42.5
Child nutrition and other food-----	2.7	3.4	3.6	3.9	4.1	4.3	19.3
Housing assistance-----	2.6	3.1	3.9	5.1	6.5	8.0	26.6
Medicaid ³ -----	2.1	2.4	2.6	3.0	3.2	3.5	14.7
Subtotal, Path B-----	39.0	41.3	44.0	46.8	48.7	50.6	231.4
Differences:							
Path A—Path B-----		3.3	8.1	9.1	7.4	4.8	-----
Cumulative difference-----		3.3	11.4	20.5	27.9	32.7	-----

¹ Calculated from data supplied in CBO, "Staff Working Paper for 5-Year Projections, 1977-81."

² While these programs aid mostly employable individuals or family heads, some recipients are incapacitated and unable to work. Also, some able-bodied parents must care for young children if adequate child care is not available.

³ These outlays are one-fourth of the Federal share of medicaid; the remainder is spent for the aged, blind, and disabled.

Many persons hesitate to look for work or accept a job if the take-home pay—salary net of work expenses, taxes, and the loss of income maintenance benefits—is too low. For example, the earnings limit which is linked to social security payments discourages employment for the elderly while a lack of day-care facilities and the cost of those that are available reduces female employment. In addition, the design of unemployment compensation and welfare programs may reduce work effort because benefits are reduced as income rises.

In some cases, reducing the disincentives may increase measured unemployment during a recession. Removal of the disincentives, however, may be a clear addition to the social welfare once high employment rates are restored.

In the case of unemployment compensation, generous benefits and extended periods of eligibility may also increase measured unemployment. Some persons would drop out of the labor force if job search was not a condition for receiving unemployment compensation. A more serious concern is a possible reluctance to accept employment unless a job would provide substantially more take-home pay than unemployment compensation.⁷ The possibility that unemployment compensation may be a deterrent to a vigorous search for work is one reason for the Administration's reluctance to renew the additional 26-week extension of insurance payments. An alternative is to make unemployment compensation less attractive; by making the program means-tested (one would have to be both poor and unemployed to collect) rather than insurance, or by taxing the benefits (see p. 48).

EXTENSION AND REVISION OF UNEMPLOYMENT COMPENSATION

The fiscal 1977 budget—on a current policy basis—would require approximately \$19.2 billion for unemployment compensation.⁸

Currently, many State unemployment insurance funds are depleted and Federal loans have been extended to maintain the liquidity of programs in States where insured unemployment has been high and prolonged. Such loans totaled \$8.5 billion in fiscal 1976 and it is anticipated that an additional \$7.6 billion in loans will be required in fiscal 1977. The Administration has proposed an increase in unemployment insurance taxes to eliminate the trust fund deficit. The proposed increase in the payroll tax, however, will increase labor costs and thereby increase unemployment and the inflation rate.

The massive unemployment which accompanied the 1974-75 recession led to an extension of the maximum insurance eligibility period from 26 to 65 weeks under Federal Supplementary Benefits (FSB) program. In addition, Special Unemployment Assistance (SUA) was made available for workers who were not normally covered by unemployment insurance. The estimated cost of the latter program, including 26 weeks of benefits at the same level as that of unemployment insurance, is \$1.3 billion in fiscal 1976.

Levels of unemployment insurance benefits and the special program differ in benefit payments from State to State; these programs provide 50 to 67 percent of the average gross weekly wage of manufacturing employees in the various States, up to some limit. However, since wages are subject to social security and income tax withholding while unemployment benefits are subject to neither, unemployment benefits generally replace between 60 and 80 percent of lost net income for workers making less than the limit.

If lost fringe benefits are taken into account, however, replacement rates are overstated.

The system provides two distinct kinds of services for the unemployed. In the case of an employee who is cyclically or seasonally out

⁷ For an analysis of this issue see Stephen T. Marston, "The Impact of Unemployment Insurance on Job Search" and the ensuing discussion in Brookings, *Papers on Economic Activity* 1975:1, pp. 13-60. See also Martin Feldstein's report, "The Importance of Temporary Layoffs: An Empirical Analysis," in the 1975:3 issue of the Brookings series.

⁸ All budget figures in this section are based on CBO Path B, Five-Year Projections.

of work, the benefits enable that employee to support his household at a reduced level until such time as his employer issues a recall. Recent research indicates that 50 percent of all workers drawing unemployment insurance ultimately return to work at the same job with the same employer.⁹ In the case of an employee on indefinite layoff, the payment of benefits allows for a more intense and productive job search. To the extent that such a search goes on, the mobility of labor is enhanced as a direct result of the unemployment benefits provided.

In addition, the current system of unemployment insurance affects total national employment indirectly by helping to maintain the level of consumer purchasing power during periods of recession and high unemployment. It has been estimated that the system indirectly supports 500,000 to 1 million workers which, in effect, means that unemployment rate would be about one-half of one percentage point higher without the purchasing power represented by unemployment compensation.

COMBINING BENEFITS AND TRAINING

With all of its advantages, the unemployment insurance program is not designed to serve one important function—increasing the employability of a worker who is drawing benefits.

An alternative to a simple extension of the current system of unemployment compensation might shift the emphasis of Federal payments from income maintenance to increasing the employability of the unemployed. One possibility is to place a worker in a training program after some limited time on unemployment compensation (e.g., 26 weeks). If the unemployed participated in a retraining effort, at least two positive purposes would be served:

- (1) Benefit payments would provide recipients with an opportunity to upgrade skills and increase both their potential for employment and their range of job choices.
- (2) The program would generate employment directly for those who staffed the training programs.

If, however, the worker is only waiting to be recalled to his old job, the expense of training would be wasted.

Undoubtedly many persons would accept paid training in lieu of unemployment compensation if the option was available. Making training or employment a requirement for continued compensation after, say, 26 weeks is clearly another matter. Whether the reduction in benefits for those who would rather forego unemployment compensation than undertake training is either appropriate or worth the increase in discipline problems is a matter of judgment.

TAXATION OF UNEMPLOYMENT BENEFITS

The current unemployment insurance system fails to differentiate among the unemployed on the basis of need. To the extent that unemployed individuals were previously employed at high salaries, have employed spouses, or have substantial current income from investments, benefits are less important to sustain income levels or to

⁹ Martin Feldstein, "The Importance of Temporary Layoffs: An Empirical Analysis," *Brookings' Papers on Economic Activity* 1975:3, p. 725.

insure current consumption. All unemployment benefits are currently tax exempt. The decision not to treat these benefits as taxable income will reduce fiscal 1976 revenues by an estimated \$3.3 billion, and fiscal 1977 revenues by \$2.9 billion. Taxing these benefits would increase the tax burdens only of those taxpayers with substantial income during the year from sources other than unemployment benefits. The resulting increase in Federal revenues could be returned to unemployment benefit recipients on the basis of need.

AFDC, FOOD STAMPS, AND MEDICAID

In addition to the receipt of unemployment benefits, a number of those who work at low wage levels or who are subject to extended periods of joblessness also qualify to receive welfare payments in the form of Aid to Families with Dependent Children (AFDC), food stamps, and Medicaid. Like unemployment compensation, these income transfers are designed to maintain income, but unlike unemployment compensation, they are unrelated to employment experience and are not financed by contributory trust funds.

While it is impossible to quantify the cost of the above programs which represent income subsidies specifically to the unemployed poor, it is possible to quantify and forecast the spill-over impact of unemployment on expenditures in these welfare programs. Unusually high levels of unemployment during fiscal 1976 are expected to increase expenditures in AFDC over and above those which would have been incurred had full employment been achieved. The Department of Health, Education and Welfare (HEW) has estimated that AFDC outlays associated with the recession will exceed \$3.9 billion. Of that figure, the Federal share will equal \$2.0 billion (35 percent of the total Federal share). The HEW figures were predicated on an unemployment rate of 8.7 percent actual versus a full employment rate of 5 percent, or approximately \$1 billion per percentage point.

The current high level of unemployment will result in an increase in expenditures for food stamps during fiscal 1976 of approximately \$1 billion over the full employment level. Additional outlays in fiscal 1977, given an extension of unemployment benefits and SUA, should reach \$0.9 billion in excess of outlays associated with a 5-percent level of unemployment.

Medicaid expenditures, of which the Federal share is equal to 55 percent, also are responsive to cyclical fluctuations in employment. To the extent that prolonged periods of unemployment result in increased eligibility for AFDC and other programs, Medicaid expenditures are expected to increase by \$1.1 billion in fiscal 1976 and by an equal amount in fiscal 1977 assuming the CBO unemployment rate assumption to be correct.

DECISIONS FACING THE COMMITTEE

Regardless of the ultimate disposition of any alternatives to the handling of unemployment compensation and special unemployment assistance, the Committee must reflect the extension or termination of these programs at current levels in the First Concurrent Resolution. Special Unemployment Assistance (SUA), established under Title II of P.L. 93-567, terminates December 31, 1976. The Federal Supplementary Benefit (FSB) program which extends benefits to 65 weeks

for unemployment compensation and 39 weeks for special compensation expires March 31, 1977. Consequently, the Committee spending target must recommend either continued extension or termination. Termination would reduce outlays by \$1.4 billion for unemployment compensation and \$1 billion for special compensation. Such termination, however, unquestionably would increase expenditures in Aid to Families with Dependent Children (AFDC) and food stamps. In the event that the extension of benefits under unemployment insurance and the new benefits associated with SUA were terminated, those States in which unemployment remained high would revert to a 39-week payment system under unemployment insurance.

The assumed rate of economic recovery also has substantial implications for future cost trends in income transfers for employables. As indicated in Table 9 (p. 45), the more rapid reduction in unemployment assumed in the "fast growth" path (Path A) reduces out-year costs for these programs substantially as compared with expenditures for the same programs under the "slow growth" path (Path B). Largely due to reductions in clientele, the fast growth assumptions result in initial fiscal 1977 savings of \$3.3 billion, peak savings of \$9.1 billion in 1979, and eventual savings of \$4.8 billion in 1981 when compared with program costs under slow growth assumptions. *Cumulative savings over the full 5-year period sums to \$32.7 billion.* Savings peak in 1979 largely due to reductions in eligible clientele who are drawn back into the economic mainstream. Savings decline after 1979 because the "fast growth" alternative results in more inflation as the economy approaches full employment and labor and resource markets tighten.

Finally, the Committee must decide whether to recommend that the Senate accept the proposed increase in unemployment insurance taxes or some alternative.

D. DIRECT EMPLOYMENT

The final policy approach is programs that put persons to work directly: public works, anti-recession revenue sharing, and public employment. Each has advantages and disadvantages.

(1) *Public works programs* typically produce useful products—roads, buildings, airports, and other necessities. Such projects employ construction workers, who are experiencing high unemployment. However, because these workers must be paid full union wages and because expensive equipment and supplies also are required, the cost of such programs per worker employed is relatively high.

Public works programs also have been criticized as anti-recessionary devices because the timing is difficult to control. Too much time passes before plans can be drawn, contracts let, and land purchased and the labor force finally hired. Similarly, projects will not necessarily be completed before the need for fiscal stimulus has passed.

The timing problem can be avoided especially in light of the expected duration of high unemployment. Financing can be restricted to projects that can be completed in 1 or 2 years—a period in which unemployment will certainly exceed desirable levels. (This is the restriction of Title 10 of Public Law 93-567; Public Works and Economic Development Act.)

(2) *A second direct employment program is anti-cyclical revenue sharing.* The purpose in this approach is to moderate recession-caused

deficits of State and local government and thereby avoid layoffs in this sector. This program has three advantages relative to public works. The net cost to the Federal government of each job created is less; the monies can be directed to those geographic areas most in need; and the moneys only flow when measured unemployment is high.

(3) *Public employment is the third alternative.* It can have the lowest net cost per job created, especially if public employment replaces unemployment compensation or welfare. The biggest drawback is the administrative difficulty of effectively using the large numbers of persons involved and the concern that the program will be demoralizing to workers and observers if the program deteriorates into leaf raking or other makework. The other drawback is the possibility that public employment workers will only displace regular public employees and produce no net gain in employment.

However, properly designed and implemented, a public employment program can partially meet other objectives very effectively. By providing income for families most in need, the major objectives of a large portion of the income maintenance program can be achieved. Moreover, by including some training, the future employability of these individuals can be enhanced.

Compared to a tax cut, public employment can provide public jobs in addition to the private sector positions created by the fiscal stimulus and thus provide more total jobs per dollar of Federal spending.¹⁰ Because public employment is likely to be the focus of so much debate and because there are so many variations on the theme, it is appropriate to consider this subject further.

PUBLIC EMPLOYMENT

Public employment is frequently proposed as a program that will maintain and improve skills, accomplish national income support goals for a large portion of the unemployed population, and provide more jobs per dollar than any alternative program. On the other hand, public employment has been criticized as inflationary, a non-productive form of Federal spending, and as a program that only replaces regular local government workers with others on the Federal payroll leaving overall unemployment rates unchanged.

It is possible to design a public employment program that will meet any one of the objectives or any of the criticisms noted above. However, no single program can be a panacea for all unemployment nor can any justify all the criticism simultaneously. Each claim and criticism must be evaluated in terms of a specific program design or characteristics. The following characteristics are important.

PURPOSE AND TARGET GROUP

Is the program primarily a response to the recession and is the target group, therefore, composed of people who were previously employed; or is the intent of the program to change the work experience of those who are chronically unemployed or underemployed?

¹⁰ *Temporary Measures to Stimulate Employment: An Evaluation of Some Alternatives.* Congressional Budget Office, Sept. 2, 1975, p. 59. This CBO paper compares the impact of all the programs discussed in this section.

ELIGIBILITY

Are there to be a limited number of positions distributed among labor regions on the basis of local unemployment conditions or is there to be a guarantee of some sort? If there is a limit to the number of positions, how will they be distributed (e.g., to veterans, to those who have exhausted their unemployment compensation, or at random)? If there is to be a guarantee, shall it apply to everyone, only those in need, or to family heads?

PAY AND DURATION

Should pay be similar to other jobs in government, equal to what the applicant made previously, or less? Should positions be permanent or created for a limited period such as 12 months?

TRAINING AND TRANSITION

If the purpose of the job is to maintain the income, skills, and dignity of the unemployed during a period of recession, then there is less need for training although there will be a need to find useful tasks. The implied goal of such jobs is transition out of anti-recession public employment into work in the private sector. However, if the purpose of the program is to help those chronically unemployed, then more training is required. The transition in this case is more likely to be to regular public employment, although training for private employment could also be a large part of the program.

CHARACTER OF THE WORK

Should the work involve assistance in on-going public activities such as public safety or education, or should it involve special projects that would not otherwise be undertaken? How important is the value of the product compared to the maintenance of employment?

With these five characteristics in mind, alternative public employment designs can be evaluated in terms of the previously mentioned objectives and criticisms.

PUBLIC EMPLOYMENT AND INFLATION

The primary objective of training programs is a better match of job openings and skills. Successful training within public employment programs should reduce inflationary pressures as the economy recovers.

If public employment is overly attractive, however, firms would be forced to inflate their wage offers in order to induce workers to return to the private sector. The inflationary effect of public employment can be avoided if the pay is low enough and/or the duration short enough so that job holders will return to regular employment when opportunities arise. A public employment program will *not* be inflationary if the wage is lower than the wage an individual is likely to be offered at regular employment. Nor will it be inflationary if the duration is restricted to, say, 12 months. It is clear, for example, that there is nothing inflationary about creating a work requirement to receive a wage no greater than current unemployment compensation.

Finally, public employment could be inflationary if it interferes with job search. Therefore, it will be necessary to design public employment programs to give the employees ample time for interviews or other work-seeking activities.

INCOME SUPPORT AND VALUE OF THE PRODUCT

An ideal program or mix of programs would assure that public employment jobs went to those most in need and that the value of the product produced by these employees compared favorably with other services provided by tax dollars. The ideal of course, cannot be achieved. A program designed to meet the income maintenance objective most efficiently would limit the money for overhead and materials required to produce a useful product. However, a program intended to produce a useful product would hire relatively high-wage construction workers for public works projects. Moreover, it is unlikely that the work product of public-employment dollars can compare favorably to that from other public dollars. Otherwise, these new activities would have been funded before those activities that are already receiving public monies.

With a fixed amount of money for public employment, trade-offs must be made between objectives for income improvement itself. Money spent for training means either fewer jobs or lower salaries for those employed.

NET VERSUS GROSS EMPLOYMENT

Displacement has been a major criticism of recent public employment programs. In some cases, State and local governments have hired public employment workers to displace those already on the State and local payroll. In other cases, workers have been laid off for some time required to qualify and then rehired on the public employment program. The criticism has often erred in assuming that the money displaced has been "lost" as an anti-recession device. However, the "lost" money acts as a disguised and somewhat clumsy anticyclical revenue sharing program for those governments who have used the funds in this way.

If the problem could not be solved in any other way, displacement could be avoided completely by using the Federal Government as the employer. A Federal program is, however, unnecessary if programs require State and local governments to maintain their effort in other regards.

GUARANTEES

The displacement problem can be moderated to some extent by providing some sort of employment guarantee even though a guarantee creates its own problems. One is cost. A guarantee makes a program open-ended and the cost high and uncontrollable. The difficulty is compounded if the guarantee induces secondary family workers to join the labor force. Another problem with a guarantee is work discipline, if the guarantee means that the sponsor must tolerate any behavior. A problem of a different sort can arise if the guarantee turns into a low-wage work requirement for eligibility for welfare.

The cost can be kept within moderate limits by making the guarantee apply only to families or unrelated individuals with little additional income. For example, the guarantee might not apply to anyone in a family with income from other sources in excess of \$5,000. The discipline problem could be solved if the Federal Government only guaranteed to pay the salary of the applicant. The worker would have to conform to the work rules of the sponsoring unit (government or non-profit agency) in order to remain employed. This requirement would alleviate the major problem of managing this large addition to the work force in an effective way and producing a valuable product. However, antidiscrimination laws would have to be vigorously policed. Finally, the work requirement problem could be avoided if the pay (say \$7,500 annually) exceeded support levels by enough so that most of the unemployed would want to take the job.

A public employment program that was targeted on families in need would increase the direct employment but reduce the income maintenance portion of the "direct response" to unemployment. Additional funds would also provide fiscal stimulus and create private sector jobs. A billion dollar program could create over 100,000 public jobs, more than 25,000 private jobs, and add no more than \$300 million to the deficit. An example of how the "direct response" budget could be reprogrammed from income maintenance to direct employment is outlined in the attached Appendix to this report.

Appendix

THE CURRENT POLICY STRATEGY

The direct response of the budget to unemployment reflects, for the most part, a system designed for relatively full employment. Education and training moneys are spent with the expectation that beneficiaries will find employment and be able to use the acquired skills. Unemployment insurance is primarily intended for those who are on temporary layoffs or temporarily between jobs. At relatively full employment most of the unemployed are new entrants or re-entrants to the labor force and the average duration of unemployment is less than 10 weeks. However, in a recession, job losers make up more of the unemployed and the duration lengthens. (See Table A-1.) Moreover, expenditures for unemployment compensation rise while the return on public and private investment in training and education falls.

Table A-1.—CHANGES IN CHARACTERISTICS OF UNEMPLOYMENT

[Dollars in billions]

	Average unemployment (percent)	Average duration (weeks)	Unemployment compensation benefits ¹	Job losers (percent)
1965 to 1969-----	3. 8	9. 5	² \$2. 7	³ 38. 3
1975-----	8. 5	14. 1	19. 4	55. 4

¹ Fiscal years 1966-70 and fiscal year 1976 estimated.

² Annual average over 5-yr period.

³ Annual average for 1967-69. Data in this category not available prior to 1967.

The depth of the 1974-75 recession led to a strengthening of the direct response to unemployment in income maintenance and to a lesser degree in direct employment programs. Unemployment compensation was expanded in coverage (via Supplementary Unemployment Assistance—SUA) and duration (via Federal Supplemental Benefits—FSB). Regular unemployment insurance benefits also expanded automatically. The number collecting benefits from State insurance programs doubled between September 1974 and April 1975. Although the Congress expanded direct employment programs with the passage of legislation funding 300,000 public employment positions, the biggest impact of unemployment on Federal expenditures was in income maintenance.

There are few who expect a quick return to 1973 levels of unemployment. Current policies describe a continuation of the strategy of unchanged expenditures for increasing employability, relatively modest increases in expenditures for direct employment, and continued

primary reliance on income maintenance. (See Figure 4 and Tables 6 and 7 in the text.) The purpose of this appendix is to describe an alternative strategy that shifts funds away from income maintenance toward direct employment and possibly training programs.

AN ALTERNATIVE STRATEGY

The vehicle for describing an alternative strategy is a public employment program targeted on households with little other income. This targeting differs from the current strategy in which neither education, unemployment compensation, nor public jobs are distributed on the basis of need. If the program is properly designed, the funds provided for direct employment can, therefore, improve on unemployment insurance as a way of meeting income maintenance needs. Moreover, if training is a component of the program, public employment can also be used to increase the employability of the work force.

Public employment cannot be evaluated in the abstract; a judgment can be made only about specific programs in a specific economic and political context. A program offering workers higher wages than they are likely to obtain in the private economy will clearly be more inflationary than one that does not. The state of the business cycle is also important. Only when there is relatively full employment will federally financed public employees be likely to displace other State and local workers or take workers from the private sector. Finally, if the budget deficit is the constraint on the amount of economic stimulus policymakers are willing to provide, then public employment can provide more jobs per dollar than any other feasible alternative. Given the high rates of unemployment projected for the next few years under even the most favorable assumptions and the political desire to limit the deficit, *there is no conflict between public and private jobs over the next few years.*

The choice is *not* between good, private jobs, and not-so-good public jobs, but rather whether public jobs should be created *in addition* to the private jobs. With the number of unemployed expected to exceed 6 million in 1978 an expansion of public employment will increase, not decrease, private employment. Moreover, the stimulation to the private sector of the public salary (less unemployment insurance) is at least equal to that of a tax cut.

PROGRAM DESCRIPTION

Assume that the program will provide 750,000 positions, the number of positions and wage rates would be:

- 500,000 full-time jobs paying \$7,500 annually for households containing children (Class A job).
- 150,000 half-time jobs paying \$5,500 annually for single-parent households containing children (Class B job).
- 50,000 full-time jobs paying \$6,000 annually for two-adult households (Class C job).
- 50,000 full-time jobs paying the minimum wage (\$4,800 annually) for single-person households (Class D job).

Eligibility for these jobs will be restricted to those who have been on unemployment for 15 weeks or whose family has been on welfare 15 weeks. Jobs will be distributed on the basis of local unemployment rates. Within the local area, a certain proportion of jobs will be targeted on those who have exhausted their unemployment compensation. Households whose income from sources, other than unemployment compensation or welfare, exceeds \$5,000 annually (\$1,250 in the previous quarter) will be ineligible. The annual income limit would be \$2,500 for households without children. With these rules, only one person from each household would be eligible.

Sponsors would be State and local governmental units or nonprofit units. These would receive \$20.00 a week to cover administrative costs and fringe benefits for each enrollee in Class A jobs and proportionately less for those in the other categories.

Fringe benefits and terms would be as follows:

Enrollees must leave the program after 12 months for a period of at least 15 weeks during which time unemployment compensation and/or welfare would resume. Employees would be entitled to participate in the sponsor's health insurance plan but not the retirement plan.

INCREASED COST OF THE DIRECT RESPONSE TO UNEMPLOYMENT

The changes in the direct response budget would be as shown in Table A-2 if the following assumptions are correct:

- (1) That the average enrollee in the Type A, C, and D jobs would otherwise be receiving \$65 a week in unemployment compensation and food stamps.¹
- (2) That enrollees in Type B programs would otherwise be receiving \$150 per month from the Federal Government for welfare and food stamps.

The change in the direct response budget is shown in Table A-2.

¹ Seventy dollars was the average weekly Unemployment Insurance (U.I.) payment in the first 10 months of 1975. The benefit received by the average enrollee could, however, be either above or below this figure. Enrollees receiving U.I. payments are likely to be household heads receiving more than the average payment. As of January 1976, the maximum weekly benefit ranged from \$60 to \$139. On an employment weighted basis, the average maximum is \$105. Among families with an unemployed household head and income under \$5,000, 35 percent received food stamps. The average monthly bonus was \$84 for families with an unemployed household head. The participation rate and average payment is likely to be higher for poor families where the household heads have been unemployed for an extended period. These overestimates of the net program cost is offset because some enrollees would not be receiving U.I. benefits if they are heading welfare families and/or have exhausted their benefits for part of the work period. The \$65 average weekly payment is consistent with the following breakdown of enrollees: 35 percent receiving \$95 weekly in combined unemployment compensation and food stamps; 40 percent receiving \$75 in unemployment compensation; 10 percent receiving \$20 in food stamps; and 15 percent receiving nothing at all.

Table A-2.—CHANGE IN THE BUDGET'S DIRECT RESPONSE TO UNEMPLOYMENT FROM A TARGETED PUBLIC EMPLOYMENT PROGRAM

Job class	Cost per job		Savings on income maintenance \$ /yr./family	Number of enrollees	Addition to job creation budget <i>Billions</i>	Reduction in income maintenance budget <i>Billions</i>	New direct cost	Total jobs and cost ¹
	Salary per year	Total per year ²						
A-----	\$7,500	\$8,500	3 \$3,400	<i>Thousands</i> 500	<i>Billions</i> \$4.3	<i>Billions</i> \$1.7	<i>Billions</i> \$2.5	
B-----	5,500	6,230	4 1,800	150	.9	.3	.8	875,000 jobs.
C-----	6,000	6,800	3 3,400	50	.3	.15	.1	\$1,800,000,000 increase in deficit.
D-----	4,800	5,440	3 3,400	50	.3	.15	.1	
Total-----				750	5.8	2.3	3.5	

¹ The indirect effect of the economic stimulus is estimated to add \$5,200,000,000 to private GNP and 125,000 persons to private payrolls. The addition in GNP will reduce the Federal deficit by another \$1,700,000,000 and reduce State and local deficits by \$600,000,000.

² \$1,000 for administrative costs and fringe benefits for class A jobs and proportionately less for the others.

³ Using \$65 per week average food stamps and unemployment compensation payment, times 52 weeks, rounded.

⁴ Using \$150 per month for food stamps and the Federal share of AFDC payment, times 12 mos. In addition, States should save another \$200,000,000 in AFDC outlays.

Type A job: Persons with 2 or more dependents, including at least 1 child, working fulltime.

Type B job: Single parent household heads with school-age children, working half-time.

Type C job: Persons with 1 dependent, working fulltime.

Type D job: Individuals with no dependents, working fulltime.

OFFSETTING INDIRECT EFFECTS

The indirect effect of the additional Federal expenditures on the private economy will partially offset the net increase in the direct response budget. The increase in the deficit will be less than \$3.5 billion because enrollees will spend their additional income increasing sales and production in the private sector. The \$3.5 billion increase in the direct response budget is likely to have a "fiscal multiplier" of 1.5, and thus increase private GNP by \$5.2 billion. The additional consumer demand will increase private employment by 125,000, increasing Federal revenues by \$1.5 billion and reducing unemployment related expenditures by \$200 million. Under these assumptions, *a program providing 750,000 targeted public employment positions will add \$1.8 billion to the deficit—\$2,400 per public job or \$2,100 per job if the private jobs created by the economic stimulus are also counted.*

The effect on State and local budgets will not be small either. The reduction in welfare will save these jurisdictions \$0.2 billion. More importantly, the stimulus to the private economy will increase their revenues and further lower welfare costs by another \$0.6 billion. In total, the savings will be \$0.8 billion, or over a \$1,000 per employee, if the foregoing assumptions are correct.

The savings to State and local governments are overstated to the extent that sponsors are required to contribute more than \$1,000 per job in administrative costs, fringe benefits, and training. The savings are understated, however, if there is any displacement of regular workers by these new enrollees or if the reduction in the non-welfare unemployment saves these jurisdictions some money. Of course, if there is displacement of regular workers then the net new jobs created by this program is also overstated.

March 24, 1976

MEMORANDUM

TO: Senator Cranston
FROM: Arnold Packer

RE: NET COST OF A PUBLIC EMPLOYMENT PROGRAM

We have estimated how the net cost per job would change if the public employment program described in the Budget Committee staff paper entitled, "Employment," was changed as follows:

- (1) The average annual wage was changed from \$6,820 to \$6,000.
- (2) The average annual cost per job was changed from \$7,733 to \$7,300.

The other assumptions remained unchanged. Namely,

(1) 32 percent of the job holders received only unemployment compensation of \$75 per week.

(2) 28 percent received food stamps of \$20 per week in addition to \$75 weekly in unemployment compensation.

(3) 20 percent received \$35 per week in food stamps and the federal share of welfare payments

(4) 8 percent received only food stamps equal to \$20 per week.

(5) The remaining 12 percent receive nothing from the federal government.

The table below gives the cost for a million jobs program. Both the direct and indirect costs are roughly proportioned to the number of positions, the costs for programs of different sizes can be calculated easily. For example, a 700,000 jobs program would have a gross, direct, and net cost of \$5.1 billion, \$2.9 billion, and \$1.5 billion respectively; or a 300,000 jobs program would have a gross, direct, and net cost of \$2.2 billion, \$1.3 billion, and \$0.7 billion respectively.

COST OF A MILLION JOBS TARGETED PUBLIC EMPLOYMENT PROGRAM

Gross Cost:	1 million x \$7,300 =	\$7.3 billion
Less Income Maintenance Savings		3.1 billion
Equals <u>Direct Cost</u>		\$4.2 billion
Less Savings from Economic Stimulus to Private Economy		\$2.0 billion
Equals <u>Net Cost</u>		\$2.2 billion

FEDERAL ASSISTANCE TO
STATE AND LOCAL
GOVERNMENTS

(61)

Preface

This paper was prepared for the use of the Senate Budget Committee in connection with its markup of the First Concurrent Resolution on the Budget for Fiscal Year 1977.

The report was prepared by Franklin Jones, Arnold Packer, Heather Ross, and Lauren Walters of the Senate Budget Committee staff and by Joel Bergsman and Peggy Cuciti of the Congressional Budget Office.

EDMUND S. MUSKIE,
Chairman.

FEDERAL ASSISTANCE TO STATE AND LOCAL GOVERNMENTS

I. *Introduction and Summary*

While the Federal Government has maintained a roughly constant 20 percent share of GNP in the postwar period, State and local governments have increased their share significantly—from 5.3 percent of GNP in 1946 to 15.3 percent in 1975. An important source of support for this growth has been increasing Federal grants-in-aid, which have grown as a proportion of both Federal and State and local expenditures. Such grants, currently over 600 in number and \$60 billion in dollar amount, and present in virtually every function, reflect the greatly increasing scale and complexity of Federal-State-local fiscal and administrative relationships.

Fiscal year 1977 presents a significant decision point with respect to those relationships. The combination of expiring existing legislation, major Presidential proposals, and significant Congressional initiatives gives the fiscal year 1977 budget a potentially key role in defining the future mix of funding and spending responsibilities among Federal, State and local governments.

EXPIRING LEGISLATION

General revenue sharing, which reaches the end of its initial 5-year funding period on December 31, 1976, and the Law Enforcement Assistance Administration, a Johnson-era block grant which has been renewed with modifications twice and currently expires on September 30, 1976, are both up for renewal. The President has recommended extension of both, for 5 and three-quarters and 5 years, respectively, with funding levels somewhat below those provided by current policy.¹

PRESIDENTIAL PROPOSALS

The President proposes to consolidate 59 categorical grants into four block grants in the areas of health, education, social services, and child nutrition, and to phase out 270,000 CETA public service jobs administered by States and local governments. Spending reductions connected with these and other Presidential recommendations would reduce total grants to State and local governments by 13 percent below current policy level, and cut the dollar amount of aid (\$60.5 billion) below that provided in fiscal year 1976 (\$62.9 billion under current policy).

¹ Current policy is the level of real spending consistent with the Congress' Second Concurrent Resolution on the Budget for fiscal year 1976.

CONGRESSIONAL INITIATIVES

The Public Works Employment Act of 1975, vetoed by the President and due for Congressional reconsideration, contains innovative proposals for countercyclical financial assistance to State and local government.² At proposed annual funding levels of \$500 million plus \$250 million for each one-half percentage point of national unemployment above 6 percent, countercyclical assistance would pay out \$1 billion in fiscal year 1977 if unemployment averaged 7 percent over the year. The Congress is also considering substitutes for the exclusion from Federal income taxation of interest on municipal bonds.

This paper is an effort to put these individual budget decisions in the broad context of evolving Federal-State-local fiscal and administrative relationships. The next section provides background information on existing State-local grant programs and on the President's fiscal year 1977 grant proposals. Section III discusses objectives of Federal grants-in-aid, and arguments for and against different objectives and techniques. Section IV presents individual fiscal year 1977 spending issues in some detail. The concluding section explores several possible future directions for Federal-State-local fiscal and administrative relations, and the sets of fiscal year 1977 spending decisions which correspond to each. Directions considered are (1) continue the growth of Federal grants to State and local governments, although perhaps not at recently experienced rates, without major change in the mix or structure of grants; (2) continue the trend toward reduced Federal control over use of grant moneys through adoption of general revenue sharing and block grants, and aim for reductions in grants, or stabilization at existing dollar levels, either now or in the future as a result of greater State-local spending flexibility; and (3) reduce general and some categorical support for State and local governments and federalize key national services to which those governments presently contribute. The conclusion is that spending decisions consistent with any of these directions can be made this year, and that the availability of countercyclical assistance provides the flexibility to move in desired directions without being inhibited by the current recession-induced strains on State-local budgets or getting locked into unwanted permanent funding commitments. Countercyclical assistance also enhances national economic recovery by providing coordinated built-in stabilization across the public sector.

II. Current Programs and the President's Proposals

CURRENT PROGRAMS

The estimated outlays of \$62.9 billion for State-local aid in fiscal 1976 represent an increase in numbers of programs as well as in budgetary significance over the last decade. In 1966 there were fewer than 350 programs with outlays of \$13 billion, comprising 9.6 percent

² Countercyclical assistance has recently repassed the Senate as part of S. 3201 the Public Works Employment Act of 1976. This new legislation provides the same amount of assistance as the earlier bill, but utilizes a more sensitive triggering mechanism and spreads the money more broadly.

of the Federal budget. If current policy levels are maintained, outlays in Federal grant programs will be \$69.8 billion in fiscal year 1977, or 16.8 percent of total Federal spending (see Table 1). While Federal grants have been increasing as a proportion of both Federal and State and local outlays, Federal control over the use of grant funds has been declining due to introduction of general revenue sharing and shifts from categorical to block grants. Categorical grants comprised 98 percent of Federal assistance in 1966; by 1976 the proportion had dropped to 76 percent.

Table 1.—FEDERAL GRANTS TO STATE AND LOCAL GOVERNMENTS (OUTLAYS)

[Billions of dollars]

Program type	1966	1976 ¹	1981 ¹
General assistance-----	0.2	7.7	8.3
Block grants-----	0	7.5	9.4
Categorical grants-----	12.8	47.7	62.1
Total-----	13.0	62.9	79.8
Percent of total Federal outlays (percent)-----	9.6	16.8	14.2

¹ Current policy levels.

State governments receive more direct Federal grant funds than local governments, although their share has declined from 88 percent in 1969 to 76 percent in 1974. The increase in the share of local governments is largely attributable to the \$4 billion per year they receive from revenue sharing. However, State governments redistribute a portion of their Federal grant funds to local governments. Since no data are available on the extent of these pass-throughs, a precise determination of the ultimate distribution of Federal funds is not possible.

In two important grant programs, Medicaid and AFDC, the grant funds are in essence passed through to individuals. In other grant programs, funds are spent by recipient governments to provide services; for example, schooling, day care, highways and law enforcement. In many cases, State and local governments are required to contribute matching funds to the federally supported activities.

The percentage of total Federal outlays in each budget function accounted for by grant programs is shown in the first three columns of Table 2.

The distribution of total Federal aid among the several functions is exhibited in the second three columns of Table 2. In 1974, income security, and education, employment training, and social services received the most grant funding. However, the relative importance of these functions, as well as of commerce and transportation, has decreased over time. The shift toward general purpose aid is shown by the increasing share of total grant outlays found in the revenue sharing function.

Table 2.—GRANT OUTLAYS BY FUNCTION

Function	Grants as a percent of total Federal outlays for each function			Percentage distribution of grant outlays among functions		
	Fiscal year			Fiscal year		
	1968	1971	1974	1968	1971	1974
050 National defense.....	0	0	0	0	0	0
150 International affairs.....	0	0	0	0	0	0
300 Natural resources, environment, and energy.....	9	16	31	2	3	5
350 Agriculture.....	12	14	23	3	2	1
400 Commerce and transportation.....	41	47	40	23	18	12
450 Community and regional devel- opment.....	73	79	68	7	10	8
500 Education, training, employment, and social services.....	66	73	75	25	23	20
550 Health.....	28	30	33	15	16	17
600 Income security.....	13	13	10	23	25	20
700 Veterans benefits.....	0	0	0	0	0	0
750 Law enforcement.....	2	15	26	0	1	1
800 General government.....	3	3	3	0	0	0
850 Revenue sharing and general purpose fiscal assistance.....	95	93	100	2	2	16
Total.....	10	13	16	100	100	100

Source: Office of Management and Budget, *Federal Government Finances* (supplemental material to fiscal year 1977 Budget).

In addition to Federal budget outlays under grant programs, State and local governments are assisted by Federal tax expenditures. Major items are detailed in Table 3. All of the tax expenditure items provide assistance of a general nature to State and local governments. The bond interest exclusion allows State and local governments to borrow at lower interest rates, but the resulting savings to them are less than the revenue lost by the Federal Government. The reduction for State and local taxes allows State and local governments to raise revenues without raising net tax burdens by an equivalent amount.

Table 3.—COST OF MAJOR FEDERAL TAX EXPENDITURES AIDING STATE AND LOCAL GOVERNMENTS, FISCAL YEARS 1967 AND 1976

[Billions of dollars]

Tax expenditure	1967	1976
Exclusion of interest on State and local debt.....	1.8	4.2
Deductibility of nonbusiness State and local taxes (other than on owner-occupied housing).....	2.8	7.1
Deductibility of property taxes on owner-occupied homes.....	1.8	3.7

Finally, State and local budget positions are affected crucially by general economic conditions and thus by the degree of overall stimulus or restraint which Federal policy chooses to apply to the economy. Each extra percentage point of unemployment above full employment creates a \$6 billion gap between State and local income and outlays, as tax revenues fall off from anticipated levels with reduced economic activity and demands for public services on the part of unemployed and other financially strapped people increase. Inflationary bursts also strain State and local government budgets, since they tend to increase interest costs, wage and salary demands of personnel, and prices of purchased goods more than they do revenues.

THE PRESIDENT'S BUDGET

The President's fiscal year 1977 proposals for aid to State and local governments would reduce both Federal spending and Federal control. Proposed grant outlay totals are \$60.5 billion, or about 13 percent below current policy budget estimates. Table 4 contrasts the President's recommendations with current policy by function, with proposed grant consolidations shown in parentheses. Consolidations account for approximately 40 percent of cutbacks recommended by the President. However, most of the other proposed cutbacks come from the same human resources areas. Key reductions are as follows:

- \$1.6 billion in community and regional development, where the President omits outlays expected as a result of the Public Works Employment Act of 1976.
- \$4.6 billion in education, training, employment, and social services, where the President plans reductions in public service employment and education. The implications of his jobs proposals are discussed in a companion paper on employment.
- \$1.7 billion in health, where funding proposed for the Financial Assistance for Health Care Act is less than current policy estimates for the replaced categorical programs, including Medicaid.
- \$1.0 billion for income security, where the proposed child nutrition block grant is confined to poor children.

The President's block grant proposals would reduce Federal control over State and local programs. Recipient governments would be freer to allocate funds to their own high priority uses, and the proposed elimination of matching requirements in many programs would further increase State-local discretion over their spending and taxing patterns. This greater flexibility could mean efficiencies in the provision of State local services and thus a reduced need for Federal grant support. It could also mean abandonment by States and localities of programs which the Federal Government initiated and previously supported.

Table 4.—FEDERAL GRANTS-IN-AID OUTLAYS BY FUNCTION

[Billions of dollars]

Function	President's budget		CBO current policy		Presidential reductions ¹ 1977
	1976	1977	1976	1977	
450 Community and regional development	4.0	3.9	4.8	5.5	1.6
500 Education, training, employment and social services	14.4	12.5	16.4	17.1	4.6
(Education consolidation)		(3.2)		(3.3)	(.1)
(Social services consolidation)		(2.5)		(2.6)	(.1)
550 Health	10.0	10.2	10.2	11.9	1.7
(Health consolidation)		(9.0)		(11.2)	(2.2)
600 Income Security	11.2	11.4	11.0	12.4	1.0
(Child nutrition consolidation)		(2.0)		(3.2)	(1.2)
Subtotal, human resources and Community and Regional Development	39.6	38.0	42.4	46.9	8.9
(Consolidations)					(3.7)
300 Natural resources, environment and energy	3.1	4.5	2.9	4.6	.1
400 Commerce and transportation	8.2	9.0	8.6	9.4	.4
750 Law enforcement and justice	.8	.8	.9	.8	0
Others	.8	.9	.8	.7	+ .2
Subtotal physical resources and law enforcement	12.9	15.2	13.2	15.5	.3
Revenue sharing and general purpose fiscal assistance	7.2	7.3	7.3	7.4	.1
Total grants	59.8	60.5	62.9	69.8	9.3

¹ From CBO current policy.

NOTE.—Numbers may not add due to rounding.

III. Objectives of Federal Assistance

Along with the complex pattern of Federal-State-local fiscal and administrative relations goes a complex set of Federal policy objectives and a complex set of arguments for and against different Federal assistance goals and mechanisms. This section considers arguments and counterarguments for (1) general support of State-local government with little or no Federal control over the use of funds, (2) categorical support for particular State-local activities, and (3) block grant support for broad functional areas of spending.

GENERAL SUPPORT

General support can take the form of continuing support, with funds steadily available year after year, or periodic support in times of general economic downturn—for example, the current recession—or specific fiscal crisis—for example, New York City. The basic arguments for continuing support are administrative ease and equity.

There are economies to be realized from operating a single, large-scale tax system and sharing its proceeds, as opposed to carrying on a multitude of smaller, competing systems.¹ Furthermore, the sharing rule can promote nationwide equality in public services by giving to poorer areas more than their proportional share of the revenues—that is, more than the proportion contributed by their citizens. Moreover, since the Federal tax mechanism, aside from social security taxes, is more progressive than the alternative State and local mechanisms, the tax burden can also be distributed more equitably nationwide based on ability to pay. This nationally supported equity helps poor areas achieve an adequate level of public services without increasing their own tax rates so high that they drive significant parts of their already meager tax base out to better-off, lower tax areas.

The chief mechanisms of continuing general support are (1) general revenue sharing, and (2) tax expenditures such as Federal income tax deductions for non-business State and local taxes and exclusion of interest on State and local bonds.

Periodic support of two kinds has received attention recently—antirecession grants and assistance to jurisdictions in fiscal crisis. The arguments for periodic support are the need for a nationally coordinated stabilization policy and the greater fiscal capacity of the Federal Government. With regard to stabilization, only the Federal Government has the ability to mitigate successfully swings in economic activity which affect the country as a whole. The greater fiscal capacity of the Federal Government assists it in meeting this stabilization responsibility, and also allows it to assist smaller jurisdictions which experience extreme fiscal strains. Failure to help State and local governments weather individual crises or nationwide recessions will often necessitate fiscal responses by them which undermine general financial stability and work against national economic recovery. Mechanisms for periodic general support include countercyclical revenue sharing and non-recurring grants, loans or loan guarantees to jurisdictions in crises.

Arguments against general support center principally on accountability. State-local governments which spend the money have it given to them rather than having to impose the necessary taxation on their own jurisdictions—they may not be as careful spenders as they would be if they had to raise the funds themselves. Citizens will be opposed to unresponsive or inefficient spending, but not as aware or as opposed as they would be if they were asked to increase their own individual taxes to pay for it. An extreme form of this accountability argument holds that availability of bailout aid to fiscally threatened jurisdictions will reward and encourage mismanagement.

The companion argument to accountability says that State and local governments can reform their tax laws and support themselves. Any lack of equitable and growth responsive taxes, notably significant progressive income taxation, results from decisions by those jurisdictions themselves, and is not a sufficient reason for Federal aid. Indeed, State and local governments have in recent years been turning increasingly to reliance on income taxation and their overall revenues

¹ These economies have sometimes been overstated. They cannot be fully realized unless individual State and local taxes are eliminated entirely, which seldom occurs. Also, they can be obtained partially by piggybacking State and local income taxes on the Federal tax system, as some jurisdictions now do.

as a proportion of GNP have grown steadily since the 1950's while the Federal Government's share remained about constant. Through Federal tax expenditures in the form of income tax deductions for State and local taxes paid, the Federal Government currently makes it easier for State and local governments to raise taxes, since part of their rise is automatically offset by lower Federal taxes. Further sweeteners or sticks are available to the Federal Government to induce further reliance by State and localities on their own tax revenues.

CATEGORICAL SUPPORT

Categorical support—that is Federal aid earmarked for specific purposes—is generally defended on the grounds of spillovers or national purposes. Spillovers occur when a jurisdiction which makes expenditures is unable to capture the full economic benefits of those expenditures. It is therefore likely to underinvest in those activities. Examples are interstate highways and water pollution controls, public education in a mobile society, and experimental programs which may identify successful innovative approaches which are then free for others to adopt (although Federal support in the last case is also defensible on grounds that the larger Federal Government is better able to invest in risky new experimental approaches). The nation as a whole can capture the full benefits of such expenditures, and therefore the National Government is an appropriate source of funds for them.

The national purposes argument recognizes different spending priorities between Federal and State and local governments. These differences most often occur with respect to programs directed at particular population subgroups, especially those subgroups which are relatively small, widely dispersed and not-well-off economically. State and local governments may prefer not to tax their constituents heavily to provide services for the poor or for generally low-productivity people, since that may tend to attract those people, who are a drain on resources, and drive out others who are healthy contributors to the tax base. The recipient groups will, in general, be so sparsely represented and economically and politically weak that they may have difficulty capturing much of a share of expenditures for themselves. If the Federal Government gave general support to states and localities, those jurisdictions might not choose to spend the money on such recipient groups, but providing the money with requirements for its use can succeed in getting the desired services provided.

Traditional mechanisms for categorical support are categorical grants, with or without matching requirements. Open-ended grant-with matching requirements reduce the cost to State and local governments of providing specified services, and leave it to those governments to decide whether and to what extent to provide the reduced cost services. This is a pure price subsidy which encourages but does not compel State-local spending along specified lines. However, other requirements regarding the level of services may also be attached, as is the case with matching grants for entitlement programs where everyone who is eligible must be served, and usually at some minimum service standard. In practice, decisions to participate in Federal matching grant programs often take on the characteristics of an all-or-nothing choice. Categorical grants without matching resemble more a contracting arrangement, with the Federal Government retaining States and localities to carry out federally defined programs.

Arguments against categorical grants concern the distortions and inefficiencies of earmarked funds and the attendant erosion of citizen control over and support for government. Distortions occur when State and local officials allocate their own revenues so as to maximize Federal grant money rather than to meet the priority needs of their constituents. They may do this through failure to think through their own priorities, or through political pressure to capture every available Federal dollar. Inefficiencies occur because the people who make the policies and write the administrative rules are not the people who carry them out. The Federal Government must work through 50 States to get its programs implemented the way it wants, and must monitor State performance. State governments face lengthy redtape to meet complex Federal standards and administrative rules and must often hire special staffs to go after Federal funds and to meet Federal reporting requirements. They lose flexibility to tailor levels and types of service to their particular needs and to reprogram funds—both Federal and their own—as changes in needs occur. The split between policy makers and program operators leads to buck passing—the former blame the latter for mismanagement and the latter the former for poor policy design, overregulation, and underfunding. No one takes full responsibility, and citizens, finding no place to successfully lodge complaints or participate in reform, develop apathy and distaste for government.

Responses to the problems of categorical grants have tended to go in two directions—proposals for federalization of programs and proposals for block grants. Federalization is suggested where the objective is to distribute resources to individuals nationwide and to relieve State and local governments of the burden of contributing to and administering the redistributed funds. Examples are welfare reform and national health insurance. Block grants are proposed when some loosening of Federal strings is desired to enable States and localities to pursue their own spending priorities with more flexibility.

BLOCK GRANT SUPPORT

Block grants provide a pool of money, to States or directly to local governments, for spending within relatively broad functional areas—for example, community development or job-related education and training. These grants are intended to provide flexibility to recipient governments in establishing spending priorities for individual programs, while retaining broad influence over the level and mix of public services and promoting a minimum level of key services nationwide. Block grants which do not change pattern of spending from what it would otherwise be are identical in effect to additional general revenue sharing. This will be the case if the receiving governments can be expected to spend more on the activities supported by block grants than the amount of the block grants themselves. Then, for example, if the Federal Government cuts back the law enforcement block grant and puts more into a child nutrition block grant, the State can simply reallocate its own funds out of child nutrition and into law enforcement so as to achieve the service mix it wants. This would appear to be the case in those present and proposed block grants where the Federal grant money is only a small portion of State spending in the block grant area—for example, law enforcement, education, and child nutrition. It is less likely to be true in areas such as commun-

ity development and employment and training where the Federal Government provides a substantial share of the dollars spent. Given the complex—and at the moment largely unknown—pattern of State block grant pass-throughs to localities, it may be true that even limited Federal dollars are indeed the marginal dollars in some local jurisdictions and are in fact helping to raise service levels in some places. Also, it is often the case that some strings and performance standards are applied to block grants—for example, Presidential proposals that all child nutrition moneys go to poor children. These requirements may be effective in influencing State-local spending patterns, but they do so, of course, to the extent that they partake of the characteristics, and the rigidities, of categorical grants.

While the effect on State and local spending patterns of moving to block grants is uncertain—and no doubt very different for different States and different functional areas—the basic premise of block grants is clear. It is that less Federal control over the use of Federal grant funds is desirable and that States are expected and intended to use their new discretion to change their spending patterns. Why should the Federal Government favor this change? Federal spending in areas that are principally State and local functions began in large part because of concern that certain important services, especially services to poor and handicapped people, were not being equitably or adequately provided. Moving back from this categorical spending must mean either that Federal priorities have changed, or that they have not changed but (1) States are now expected to support them voluntarily, or (2) categorical grants have proved to be inefficient means to achieve them. It is important to distinguish these possibilities. If it is true that Federal, State and local priorities now essentially coincide, either because Federal objectives have changed or because State and local orientations have changed, then block grants may be a good method of funding State and locally provided services, although another answer would be to get the Federal Government out of the grant business. However, if the problem is that Federal grants have gotten out of hand in number and complexity as tools for achieving distinctive Federal goals, then the responsible answer is to weed out and improve the categorical programs rather than to give the money to someone else and let them decide what to do with it.

IV. Fiscal Year 1977 Budget Issues and Options

A. GENERAL REVENUE SHARING

PROGRAM SUMMARY

General revenue sharing was first enacted in 1972. Under current law the program expires on December 31, 1976. Outlays in 1975 were \$6.1 billion; current policy levels for 1977 would be \$6.6 billion. This amounts to roughly 2½ percent of projected State-local revenues from all sources. Funds are distributed to all 50 States and some 39,000 local governments, according to a formula which takes into account population, tax effort, and per capita income. Local governments receive about two-thirds of the funds.

The President has proposed renewal through 1982, with funding of \$6.5 billion in 1977 and annual increases of \$150 million thereafter, consistent with present law.

ISSUES AND OPTIONS

More than any other program, budget issues related to general revenue sharing center on Federal control over State-local spending, and distributional impacts. As it stands, the program uses the Federal tax system or borrowing power to obtain money and distribute it to lower levels of government with virtually no strings attached. Richer jurisdictions contribute proportionately more than they receive, and poorer ones receive proportionately more than they contribute.

If the program is to be renewed, the funding level is an obvious budget issue. The President's proposed annual increases of \$150 million would fall short of the roughly \$400 million that would be needed to keep up with expected inflation of about 5 to 7 percent. The impact on Federal outlays, State-local revenues, and service levels depends on the combination of revenue sharing with all other grant programs. Federal outlays and State-local revenues can be set at desired levels by various mixes of different forms of aid. Increases or decreases in Federal control of State-local spending can be accomplished by shifting funds from general revenue sharing to more restricted forms of grants, or vice versa. Thus, funding levels for general revenue sharing inevitably form only one element in an overall strategy of how much aid, for what purposes, with what controls.

Since general revenue sharing funds are generally unrestricted as to use and are small compared to total spending by recipient governments, it is not possible to determine the actual effect of the program on State-local spending allocation among functions, recipients, etc. The reported uses of the funds may or may not correspond to the actual incremental spending allocations induced by the program. Thus, while the impact on jurisdictions is generally known, the impacts on distribution of income and services among people are not known.

Other issues, less directly related to the size of the 1977 Federal budget include (1) restructuring the allocation formula, e.g., to increase funding to cities where poverty or tax effort is high, (2) strengthening prohibitions concerning discrimination, and (3) changing the duration of forward entitlement.

B. ANTI-RECESSION ASSISTANCE

CURRENT PROPOSALS

In the past year, Congress has considered several strategies to combat recession which involve State and local governments. Congress increased funding for Title VI of the Comprehensive Employment Training Act providing a total of 310,000 public service jobs. In addition, it passed the Public Works Employment (PWE) Act of 1975 incorporating two additional antirecession programs: Title I authorized \$2.5 billion for a program of accelerated public works. Title II represented a new approach; Congress authorized an antirecession grant program which would distribute funds whenever national unemployment exceeds 6 percent. Recipients would be limited to governments hardest hit by recession. The funds could be used to insure the maintenance of basic public services.

The Public Works Employment bill was vetoed by President Ford in February. The House voted to override but the Senate vote fell short of the required two-thirds. In his veto message, the President

reserved most of his criticism for the Title I construction program, arguing that the peak impact would come too late—in 1977 or 1978—adding stimulus to the economy at a point when recovery was well underway. He expressed support for the idea of antirecession assistance, however, and recommended consideration of the Brown-Griffin Supplemental Community Development Employment Assistance Act of 1976 (H.R. 11860; S. 2986).

The three approaches, accelerated public works (Title I of PWE), antirecession grants (Title II of PWE), and supplemental community development (Brown-Griffin), are contrasted in Table 5 and highlighted below.

Table 5.—COMPARISON OF ANTI-RECESSION PROGRAMS

Bill	Trigger	Funding level	Distribution and eligibility	Use of funds
Accelerated Public Works, title I—Public works employment bill.	On congressional action---	\$1,500,000,000 authorized for appropriation through fiscal 1977.	Distribution on a project basis; project eligible only if site labor can begin within 90 days of approval. Priority to areas of high unemployment.	Construction, renovation repair or improvement of public works except dams, canals and other waterway projects.
Anti-recession Grants, title II—Public works employment bill.	Whenever national unemployment exceeds 6 percent.	Funding authorized for 5 quarters. Amount available for obligation per quarter equals \$125,000,000,000 plus \$12,500,000 for each 0.1 percent of unemployment above 6 percent in the previous calendar quarter.	Eligibility limited to general purpose governments in areas with unemployment above 4.5 percent. One-third of available funding is set aside for eligible State governments. Distribution by formula based on general revenue shares and excess unemployment. Excess unemployment is the difference between the current rate and 4.5 percent. All units within a State for which separate unemployment rates are not calculated, are treated as one for purposes of determining formula allocation.	Maintenance of basic services. Cannot be used for major construction.

Table 5.—COMPARISON OF ANTI-RECESSION PROGRAMS—Continued

Bill	Trigger	Funding level	Distribution and eligibility	Use of funds
Brown-Griffin supplemental community development assistance.	Whenever national unemployment exceeds 7 percent.	\$780,000,000 authorized for appropriation. Amount available for obligation per quarter equals \$15,000,000 for each tenth of a percent unemployment above 7 percent in the previous calendar quarter.	Eligibility limited to general purpose local governments in areas with unemployment higher than 8 percent. Three quarters of available funding is distributed by formula to metropolitan cities and urban counties. Remainder distributed to States for use by smaller localities with high unemployment.	Any labor intensive activity consistent with the community development plan.

- Triggers:* Both antirecession grants and Brown-Griffin are triggered by national unemployment. The antirecession grants had a threshold of 6 percent unemployment; Brown-Griffin 7 percent. Accelerated public works would have become effective immediately upon appropriation of funds.
- Funding levels:* Brown-Griffin authorizes funding at a substantially lower level than did the vetoed Public Works Employment bill. Were the unemployment rate to remain constant at 7.5 percent through the end of fiscal year 1977, over \$4 billion would have been made available for obligation by the Public Works Employment bill (\$2.5 billion for accelerated public works; \$1.6 billion for antirecession assistance); Brown-Griffin would authorize only \$375 million under the same circumstances.
- Who is eligible:* The public Works Employment bill qualifies more jurisdictions for funding than does Brown-Griffin. Funds for accelerated public works (Title I of the PWE bill) are distributed on a project basis; antirecession grants (Title II of the PWE bill) and supplemental community development assistance (Brown-Griffin) are both distributed primarily by formula. Any State or general purpose local government with unemployment higher than 4.5 percent is eligible for Title II funding; only local governments with unemployment above 8 percent can receive supplemental community development assistance.
- Use of assistance:* Antirecession grants can be used to purchase materials and labor necessary for the maintenance of public services. Brown-Griffin funds can be used for any activity—construction or otherwise—consistent with the community's development plan. Accelerated public works would, of course, be limited to construction activity.

IMPACTS OF THE OPTIONS

There are two separate though complementary goals to be achieved by programs offering countercyclical assistance; to stimulate economic recovery and to moderate the negative impact of recession on State and local government services.

To be effective a program must create new demand and stimulate jobs with expenditures in the right amount, in the right places, at the right time. In a recessionary period, accelerated public works and supplemental funding for community development will almost certainly create new jobs since a high proportion of community development and major construction money comes from the Federal Government and more money will mean more activity. Antirecession grants are likely to be used to fund services previously provided, and will have a stimulative effect if they prevent a community from having to raise taxes or cut services in response to declining revenues.

For the greatest impact, stimulus should be applied as soon as there is clear evidence of recession. Once recovery is well underway, stimulative programs may have an inflationary impact as they require resources which are becoming scarce. Given the present stage of

recovery, the greatest difficulty with respect to timing is likely to arise from a public works approach, which often requires substantial start-up time and lengthy spend out. However, accelerated public works can be effective in a short time if administration is efficient and emphasis is placed on smaller projects. The Brown-Griffin bill may have similar timing difficulties as well, because (if the experience of the existing community development block grant program is a relevant guide), a substantial proportion of the funds may be used for construction activities. However, repair and renovation projects are possible alternative uses. Such projects could be completed fairly rapidly. Since antirecession grants are to be used to fund ongoing services, their impact should be felt relatively quickly.

A one percentage point increase in the national unemployment rate creates a gap between declining State-local revenues and increasing state-local service demands of \$6 billion. At 7.5 percent unemployment, the budgets of State and local governments would be adversely affected by \$21 billion compared to what they would be if unemployment were only 4 percent. That is, these governments in the aggregate would have to raise taxes, reduce spending, or drawdown previously accumulated surpluses by \$21 billion. Thus, \$6 billion per percentage point of extra unemployment would be the amount of Federal assistance required to hold these governments fully harmless from the effects of recession. To be most efficient, this money would be carefully allocated among individual jurisdictions to recognize the very different fiscal positions of different State and local governments.

C. LAW ENFORCEMENT ASSISTANCE

PROGRAM SUMMARY

The LEAA program begun in 1969, expires at the end of fiscal year 1976. Outlays were \$0.9 billion in 1975 and the current policy level for 1977 is \$1.0 billion. The President has proposed to renew the program but at a reduced budget authority of \$0.7 billion in 1977.

LEAA grants account for approximately 1½ percent of total Federal aid to State and local governments, and 5 percent of total State-local outlays on law enforcement. Thus even major changes in the program would have only small effects on the Federal aid picture, general economic conditions, or the fiscal positions of recipient governments. The more important impacts are in terms of the details of State and local law enforcement activity. These impacts have been the subject of considerable controversy.

ISSUES AND OPTIONS

Much of the controversy about LEAA relates to what extent the program should simply provide financial assistance to local law enforcement agencies (or, more widely, criminal justice systems) as opposed to retaining more Federal control of funds to insure that they are spent on research, demonstration, and other projects expected to produce innovations in law enforcement practices. A block grant approach is more appropriate to the former, while more federally controlled projects would offer a greater chance of achieving the latter, for a given amount of money. A second issue has been the focus on

law enforcement versus the entire criminal justice system; LEAA has been moving away from an initial heavy concentration on law enforcement toward somewhat greater emphasis on other parts of the criminal justice system, including assistance to States for comprehensive systemwide planning. Options for FY 1977 include elimination of LEAA, renewal without change at current or reduced funding levels, or targetting of resources on development of innovative approaches to improved criminal justice.

D. EXCLUSION FROM FEDERAL INCOME TAXES OF INTEREST ON MUNICIPAL BONDS

PROGRAM SUMMARY

This tax expenditure will cost the Treasury an estimated \$4.5 billion in 1977. The exclusion provides direct assistance to State and local governments by reducing the interest rates they pay. However some bond purchasers receive more interest than needed to induce them to buy the bonds; an estimated 25 percent of the benefits of the Federal tax expenditure is diverted in this manner from State and local governments.

FEDERAL SUBSIDY OF TAXABLE BONDS

State and local governments could be given the option of issuing taxable bonds on which a portion of the interest costs would be paid by the Federal Government. CBO estimates based on a 40-percent subsidy indicate that initial year gross subsidy costs could be as high as \$1.4 billion. Increased revenues would offset the subsidy cost to the extent that investors substitute taxable investments for current holdings of tax-free municipals. The offset could be as high or even higher than the amount of the subsidy, but the actual response is very difficult to predict and would depend on the availability of alternative tax shelters. Subsidy costs and any revenue offsets would rise over time, as more subsidized taxable bonds were issued.

ESTABLISH FEDERAL GUARANTEES OR INSURANCE, A DEVELOPMENT BANK OR OTHER POOLING MECHANISM

All of these options move toward Federal assumption of risk. A public authority could raise funds by selling taxable bonds at market interest rates and then lend to State and local governments. If a subsidy were desired, the re-lending could be at a lower interest rate with the difference met through Congressional appropriation. A variant of this approach would have the Federal Government assist States in establishing development banks through insurance or direct subsidy; others are Federal guarantees or insurance. A development bank or other pooling mechanism would especially increase the marketability of bonds issued by small jurisdictions. All of these options would reduce or eliminate the discipline now imposed on state and local governments by the need to market their own bonds. Replacing this discipline by some sort of Federal review, differential insurance premiums, or other mechanisms is possible in theory but poses potentially thorny political and administrative problems.

OTHER OPTIONS

Repeal of the exclusion could also be compensated by increased general revenue sharing, and/or by grants for capital expenditures.

Most of the other kinds of assistance would increase Federal control, at least to some extent, and many of them might increase State-local uncertainty as to future benefits.

E. THE PRESIDENT'S PROPOSALS FOR CATEGORICAL GRANTS

THE OVERALL PICTURE

As already noted, the President's 1977 budget would reduce Federal spending as well as Federal control in categorical programs. Budget-wide, the President's proposals for grants are \$60.5 billion, which is 13 percent below current policy budget estimates for the year. Most of the cuts come in categorical grants in human resource programs. For all human resource programs combined (functions 500, 550, 600, and 700), the President's proposed grants to State and local governments are \$7.3 billion or 18 percent below current policy. For general assistance (function 850) his proposals are \$0.1 billion, or 1 percent below, and for other areas his proposals are \$1.9 billion, or 9 percent, below current policy.

It is very hard to predict the net distributional impact of these cuts on individual States and local jurisdictions or the responses of State-local governments to such cuts. Many recipient governments may be able to continue current service levels, some perhaps even without tax rate increases. Others will have to cut assistance and/or increase tax rates. The ultimate impacts on State-local fiscal situations, program beneficiaries, and taxpayers will vary considerably among jurisdictions.

The President's proposals would reduce Federal control over State and local programs. Consolidation of categorical programs into block grants in health, education, child nutrition, and social services will permit States more freedom in allocating their own and Federal funds according to their own priorities. Elimination of matching requirements in many programs will further increase State-local flexibility in how much is spent in each area. As with the other options, the President's proposals for grant consolidations can be dealt with separately from his proposed funding levels.

In health, child nutrition, and education, the President has proposed major structural changes: Most or all of the categorical programs in these areas are proposed for replacement by block grants. Table 6 summarizes the proposals.

HEALTH

Federal aid is just under \$10 billion per year. This is 40 percent of State-local outlays for health, and about 8 percent of all public and private spending in the area. The President proposes to reduce outlays for Federal grants in the health function by \$1.7 billion, or about 17 percent, in fiscal 1977 as compared with current policy levels. A key element of the President's proposal is the consolidation of Medicaid, the developmental disabilities program for retarded persons, and 14 other health programs in a single block grant to

Table 6.—COMPARISON OF PRESIDENT'S POLICY FOR BLOCK GRANTS PROPOSALS (BUDGET AUTHORITY)

[In billions of dollars]

	Fiscal year 1976 current policy	Fiscal year 1977		
		Current policy	President's request	Difference
Health:				
Medicaid				
Maternal and child health				
Community health center				
Family planning				
Community mental health				
Alcohol abuse				
Other programs				
Total-----	9.6	11.0	10.0	-1.0
Child Nutrition:				
School lunches				
Commodity distribution				
School breakfast				
Special milk				
Other programs				
Total-----	2.7	3.2	2.0	-1.2
Education:				
Vocational education				
Handicapped				
Adult education				
Library resources				
Other programs				
Total-----	3.6	3.8	3.3	-.5

States. The only major Federal health programs currently aiding States and localities that would not be included in the new block grant are drug abuse, health maintenance organizations, professional standards review organizations and the National Health Service Corps. Outlays for the block grant would be \$1.5 billion less than the amount necessary to maintain current policy for the individual programs they would replace. The remaining \$0.2 billion in reductions is mostly for health manpower programs.

Under the President's proposals, services would be concentrated on low-income populations, thereby providing more assistance for some of the neediest people and achieving greater equity among the different State programs. The cuts proposed by the President would be concentrated in States now supplying high levels of services. These States would face a significant fiscal squeeze, because the cuts amount to about 7 percent nationwide of total State-local spending on health. Thus, States where services are now high would either have to cut back services or increase taxes under the new block grant allocation procedures. In addition, with the elimination of mandatory cost sharing under the President's proposed plan, the total amount of public

sector funding for health care services is likely to be reduced. The programs most likely to be reduced are those now emphasized in the Federal grants, such as out-patient services, community health care, and home health care and screening programs.

EDUCATION

The President's proposals would reduce Federal outlays for elementary and secondary education by \$1.6 billion below current policy levels, and release programmatic controls over 27 special-client programs by consolidating them into a block grant. Most of the President's cuts are concentrated in programs for the economically disadvantaged and students with special needs.

The Federal share of public school expenditures increased during the early 1960s but has remained stable since then at around 8 percent of the total. The State-local split of the remaining 92 percent differs considerably for State to State.

The combined effect of the President's funding and consolidation requests would depend on State-local structures and responses; the effects will surely vary by State and by locality. Efficiencies due to the added flexibility in the President's consolidation proposal may offset part or all of the difference in funding from current service levels. States and local governments may absorb part or all of the added costs of maintaining current service levels through increased taxes, available revenues, or shifts in program priorities. The overall fiscal impact would be small, because the proposed cuts are only around 1 percent of aggregate State-local spending for education.

Federal education programs presently attempt to focus on economically disadvantaged groups and those with special education needs, such as the handicapped and bilingual. Negative effects on these groups may be less where the groups are highly concentrated and well organized (e.g., Chicanos in the Southwest, the handicapped in Maryland and Massachusetts) or where exemplary State programs currently exist (e.g., compensatory education programs in Michigan and California, and programs for the handicapped in Washington, New Jersey, Michigan, California, North Carolina, and Massachusetts). However, where program efforts have been exclusively Federal or where affected subpopulations are dispersed or poorly organized, the current beneficiaries are more likely to be adversely affected.

CHILD NUTRITION

There are now 15 child nutrition programs which will cost the Federal Government \$2.7 billion in fiscal 1976. The President proposes to consolidate all of these programs under a Child Nutrition Reform Act (block grant), at a funding level of \$2.0 billion for fiscal 1977 compared to a current policy estimate of \$3.2 billion. Local matching requirements are to be eliminated.

In fiscal 1976, it is estimated that over \$4.9 billion will be spent by Federal, State, local, and private sources for the purpose of maintaining the nation's child nutrition programs.

Of the total, 54 percent will be provided by the Federal Government, 20 percent by State and local sources, and the remainder by recipient children.

Under the President's proposal, non-needy students would be most affected by the proposed block grant. Approximately 15 million students (about 30 percent of the national school enrollment) could be affected. If Federal funds were no longer available to fund lunches for non-needy students, school food service systems could continue to serve them either at a higher meal charge to the student, or with greater state and local contributions, or a combination of both. If the entire additional cost were borne by the non-needy student, meal charges would increase by approximately 25 cents (up from an average of 50 cents presently), and the cost of a half-pint of milk would increase by about 5 to 7 cents (up from 6 cents presently). The total cost to be borne, then, to make up this price increase would be approximately \$750 million. (The remaining \$450 million in reduction from the current policy level results from caseload growth expected under current law for which there would be no new funds.)

Rural elementary school children from families above the poverty line and primarily from the Southeast, Southwest, and Midwest would most likely be adversely affected by the block grant. Infants (under age 1) now receiving benefits in the special supplemental feeding program would be excluded from being served under the grant monies.

V. Conclusion

Over the last 2 decades, total government outlays have increased steadily as a proportion of GNP, due principally to the growth of State and local government expenditures. A significant source of support for increased State and local spending has been increased Federal grants in aid, which have risen as a proportion of both Federal outlays and State and local outlays. At the same time, Federal control over State and local uses of grant funds has declined, through moves to general revenue sharing and block grants. A basic question underlying this year's budget decisions is—"Should these trends continue?"

The current recession complicates this year's decisions. Grant increases will help state and local governments over a difficult period when their revenues are cyclically low and their service demands cyclically high. Grant reductions will in most cases disrupt strained State and local budgets and prompt service cutbacks and tax increases which will work a hardship on people in need and undermine national economic recovery. However, directions can be set which will allow fiscal relations to develop along desired future paths. Antirecession grants provide a flexible tool to address the current needs of State and local governments and national economic recovery without forcing long-run Federal-State-local fiscal relationships down any particular path.

For the longer-run, a number of structural directions are possible. One which has been recommended by the Labor and Public Welfare Committee involves grant increases above current policy level—principally for education and jobs—without major change in program structure. Another is to follow the President's conceptual approach and (1) renew revenue sharing with multiple year funding, (2) extend the Law Enforcement Assistance Administration block grant, and (3) consolidate existing categorical programs into four new block grants in the education, health, child nutrition, and social services

areas. This will continue the trend toward less Federal control, which should result in program efficiencies and a reduced or stabilized need for Federal aid. Spending options corresponding to this choice concern how much saving over current growth trends is possible and how quickly it can be realized. The major options include:

- Maintain expenditures at current policy level for fiscal 1977 and aim to stabilize the dollar amount or reduce the rate of growth of Federal grants over the period 1978–80 as a result of consolidation.
- Accept the President's proposal of \$9.3 billion in cutbacks from current policy, which will reduce the dollar amount of fiscal year 1977 Federal grants slightly below their estimated fiscal year 1976 level.
- Make selective consolidations this year, but not as broad as proposed by the President, and selective grant reductions or stabilizations where efficiencies can be achieved or functions eliminated.

A third possible direction is toward considerably reduced Federal grants to State and local governments, continued Federal control over use of the remaining funds, and federalization of key national services such as welfare and health finance, which will eliminate the need for sizable State and local matching contributions. This approach could result in a higher or a lower effective level of support for State and local governments depending on the relative size of reductions in State and local financial obligations and Federal grant assistance. Decisions this year which correspond to this direction include—

- adoption of renewed general revenue sharing with provision for less than 5-year funding;
- elimination of LEAA block grant, with limited funding retained for specific innovative approaches to improve criminal justice; and
- commitment to key national service programs, such as welfare reform and health insurance, to be bought in the future with the proceeds of economic growth and reduced general support for State and local governments.

Under all of the above possibilities, properly scaled antirecession grants are appropriate to address current State-local fiscal needs without making any unwanted permanent funding commitments.

This year's decisions can serve both the short-run and the long-run. If one wishes to achieve long-run goals of stabilized or reduced size of government or savings from grant consolidation, there is no need to cutback sharply on grants and disrupt State and local fiscal positions now in order to do so. At the same time, if one wishes to move in a new long-run direction, there is no need to sacrifice this year's important opportunity to do so on account of concern for the present strained condition of State and local budgets.

TRENDS AND ISSUES IN
FEDERAL RETIREMENT AND
DISABILITY PROGRAMS

(S7)

Preface

This paper was prepared to provide background for the deliberations of the Senate Budget Committee prior to its markup of the First Concurrent Resolution on the Budget for Fiscal Year 1977.

The report was prepared by James R. Storey of the Senate Budget Committee staff. Franklin Jones, Senator Domenici's staff representative on the Committee staff, made a major contribution to the report. Also contributing to the report were Becky Beauregard and Karen Schubeck of the Committee staff and Jack Burby, an editorial consultant. Numerous staff of the Congressional Budget Office developed background materials from which much of the factual material in the report was drawn.

EDMUND S. MUSKIE,
Chairman.

(S9)

TRENDS AND ISSUES IN FEDERAL RETIREMENT AND DISABILITY PROGRAMS

I. Summary

Over one-third of Federal outlays are devoted to the replacement of lost income or income supplementation for Americans who are retired, disabled, or the survivors of deceased breadwinners. Nearly one-third of all Federal revenues are derived from the special taxes levied to fund these retirement systems. And nearly half the yearly growth in the current services budget results from rising numbers of beneficiaries entitled under these programs, from automatic cost-of-living increases for these beneficiaries, and from higher real benefits caused by a rising wage base.

Estimated outlays for retirement programs in fiscal 1977 under current law will total \$150 billion, about \$87 billion of which is for social security and railroad retirement benefits. Another \$29 billion goes for Medicare and the Federal share of that part of Medicaid that aids the aged and disabled. Civil service and military retirement account for \$18 billion, and veterans disability compensation and pension benefits total \$8 billion. Welfare programs for the aged and disabled will pay out \$6 billion.

A number of policy issues, particularly the issue of social security financing, are important in the context of the 1977 budget and the period of 1977 to 1981. However, these issues must be considered in a broader context for two reasons: (1) the long-range projections for social security show a large deficit in the 21st century, due in almost equal measure to adverse demographic trends and to the "coupling" problem;¹ and (2) many beneficiaries under one retirement program draw benefits from others concurrently, so that individual program issues necessarily interact with each other. Thus, alternative approaches to short-run problems must allow for their likely impact on long-range financing problems and for their effects on all related benefits considered as a single system. The following paragraphs describe the major issues of immediate interest this year.

¹ "Coupling" refers to a problem in the way social security benefits are adjusted for inflation. The adjustment affects not only current benefit payments but also future benefits for people now working. This results in their being overcompensated for inflation.

A. SOCIAL SECURITY

In May 1975, the Social Security Trustees reported an anticipated deficit in the trust fund ² by the early 1980's. This forecast was based on a rapid rise in benefits responding to double-digit inflation, and shortfall in revenues due to the recession. Since that report, official but unpublished projections are more optimistic. They show trust fund reserves declining to \$30 billion (about 3 months worth of benefits) in fiscal 1981. A projection by CBO has the reserves bottoming out at \$28 billion in fiscal 1980 and rising in the next year.³

Although the outlook is now more optimistic for the short-run, the President has proposed raising the tax rate by 0.3 percent each for employee and employer (from 5.85 percent of covered wages to 6.15 percent). This would raise fiscal 1977 revenues by \$3.3 billion (\$4.4 billion for a full year). Reserves in fiscal 1980 would amount to 4 or 5 months' worth of benefits. This proposal has been criticized for three reasons: (1) it will add to the cost of goods and services, thereby contributing to inflation; (2) it reduces the proposed fiscal stimulus of further income tax cuts; and (3) it would combine an increase in a regressive tax with a proposal to reduce the progressive income tax.

There are a number of alternatives available to Congress including the following:

(1) *Action could be delayed for a year or two* if the financial situation permits, so that appropriate action for the short-run can be considered and developed as an integral part of the long-run solution. A delay would cost the fund between \$1.5 and \$5 billion for each year of delay, to be recovered over the actuarial period of 75 years.

(2) *Limited changes could be made now* in the tax and/or benefit structure which might be deemed an appropriate part of any remedy for the long-range problem. This would reduce the pressure to develop an integrated solution quickly. Alternatives for limited changes include:

(a) *Increasing the wage base*, which redistributes the tax burden toward those persons who earn wages higher than the current maximum of \$15,300. It could be argued that these individuals could most easily bear the additional burden, which would be at no greater rate than that paid by lower wage earners, and on no greater portion of their wages. On the other hand, the higher wage base would generate higher benefits in the future, although not by enough to increase the longrun deficit. Consideration also must be given to the potential adverse effect on private investment markets and on private capital formation.

(b) *Eliminating the ceiling on the wage base for the employer only* is a possible long-run remedy because it does not result in higher employee benefits in the future. However, it would be a sharp tax increase for employers, which might be passed on to workers through smaller wage increases or in shifts between capital and labor.

(c) *Use of part of the Medicare payroll tax for cash benefits* was

² This discussion refers to a combination of two trust funds: the old-age and survivors insurance trust fund; and the disability insurance trust fund. Medicare is financed through two other trust funds: the hospital insurance trust fund; and the supplementary medical insurance trust fund.

³ Congressional Budget Office "Five-Year Budget Projections" report presented in testimony before the House Ways and Means Subcommittee on Social Security on February 3, 1976.

proposed by the 1975 Social Security Advisory Council. Medicare does not face a shortrun deficit, but advocates of expanded health insurance oppose such a transfer of funds.

(d) *Some selective benefit reductions*, such as those proposed in the President's budget, can be made, but large savings cannot be realized in the short run without the risk of creating hardship among current beneficiaries or those about to retire.

(3) *A general fund grant* can be made to the fund. It would be neutral in its interaction with remedies for the long-term deficit, and it would not result in permanent benefit increases. However, a temporary Federal transfer could become a permanent habit. If it became permanent, it would constitute a basic change in the self-financing structure of the social security program.⁴

(4) *Congress could provide authorization for the manager of the fund to borrow from the Treasury* in the event that the fund exhausted its reserves. Since such borrowing would be used only in the event of actual depletion, it would permit the system to retain its self-financing structure and would not require as large a reserve fund.

(5) *A new tax could be levied on energy or another commodity*, with the funds earmarked for social security. Such a proposal aims at replenishing the social security funds with a socially useful tax (e.g., a tax on energy to encourage conservation).

B. MEDICARE

The President has proposed protection against catastrophic health care costs for services covered under Medicare. No beneficiary would have to pay more than \$500 in yearly out-of-pocket costs for covered hospital services, or more than \$250 for covered physician's services. The cost of such protection (\$430 million) would be more than offset by other proposals to increase beneficiary cost-sharing and to limit increases in fees reimbursable under Medicare.

A plan to protect all Americans against catastrophic illness has been proposed by Senator Long (S. 2470). His bill would also federalize and reform Medicaid. The total first-year net additional cost of the bill would be about \$10 billion.

C. FEDERAL EMPLOYEE RETIREMENT

When cost-of-living adjustments are applied to benefits under the civil service and military retirement systems, an extra 1 percent is added to the consumer price index increase to make up for the time lag between the effects of inflation and the adjustments to retirees' checks. But this extra 1-percent factor overcompensates retirees for inflation over the long run, and the President has proposed a repeal of this provision.

The President's proposal would save \$182 million in fiscal 1977; by the year 2000, this saving will grow to \$6 billion a year. Alternative measures may be proposed in Congress, such as dropping the 1-percent add-on but making a lumpsum adjustment each time a retiree gets a cost-of-living increase. While this would save money in the long run, near-term outlays would be increased.

⁴ Some advocates have proposed a permanent general fund contribution equal to the employees' contribution, or one-third of total funding. Congressman Burke, Chairman of the House Subcommittee on Social Security, favors this approach.

There is also interest in basic reform of the military retirement system. One major issue is whether or not the system should be made contributory like the non-military programs.

D. OTHER LEGISLATION

The Senate has passed a bill to reform the VA pension program (S. 2635). The House is considering amendments to the SSI program (H.R. 8911 and 8912) and the black lung benefits program (H.R. 10760). The first-full year cost of these bills would be almost \$2 billion. The House is also considering a liberalization of the retirement income credit, which would reduce annual revenues by \$340 million.

II. Importance of Retirement and Disability Programs to Fiscal Policy

BUDGET IMPACT OF RETIREMENT AND DISABILITY BENEFITS

The Federal role in provision of income to the retired, disabled, and survivors accounts for 35 percent of all Federal outlays, 37 percent of the growth in outlays from 1975 to 1976, and 45 percent of the expected growth in a projected budget level that would maintain current policy from 1976 to 1977. The trust fund revenues earmarked for these programs amount to 31 percent of all Federal revenues. Thus, future policy for retirement programs will have a major impact on future budget options, both on expenditures and revenue collections.

According to the President's budget, fiscal 1976 outlays under current law for retirement and disability programs will total \$131 billion, and earmarked revenues will amount to \$105 billion. The fiscal 1977 figures are \$150 billion in outlays and \$123 billion in revenues. The detail by program is as follows:

[In billions of dollars]

Program	Fiscal year 1976		Fiscal year 1977	
	Trust fund revenues ¹	Outlays	Trust fund revenues ¹	Outlays
Social security (OASDI)-----	69.8	72.7	80.0	83.6
Medicare (HI and SMI)-----	18.5	17.5	23.0	21.9
Railroad retirement-----	3.5	3.4	3.7	3.7
Coal miners' benefits-----		1.0		.9
Federal employee retirement-----	13.0	8.6	15.9	9.9
Military retirement-----		7.4		8.5
SSI ² -----		5.5		5.9
Medicaid (aged, blind and disabled portion) ² -----		6.2		7.0
Veterans' compensation-----		5.0		5.2
Veterans' pensions-----		3.0		2.8
Food stamps (aged, blind and disabled portion)-----		.3		.3
Total-----	104.8	130.6	122.6	149.7

¹ Programs with no revenues shown are funded from general revenues. Those with trust fund revenues also receive some transfers from general revenues as set forth in the particular statutes involved.

² These Federal outlays are matched or supplemented by additional outlays of State and local governments.

FUTURE TRENDS

Retirement benefits will continue to be a growing sector of the Federal budget, assuming a continuation of current law.

There are three major factors accounting for growth in these programs. First, except for veterans' benefits, these programs are all adjusted automatically for inflation. Such adjustments account for 62 percent of the growth in outlays from 1975 to 1976.

A second major growth factor is a rising beneficiary population. In addition to the general population increase, program beneficiaries rise due to past changes in law, or because of such factors as a growth in the number of Federal civilian and military employees in prior decades producing more Federal retirees and veterans in this and future decades. Increasing numbers of beneficiaries accounted for 19 percent of growth in spending on retirement benefits from 1975 to 1976.

A third factor in growth is a rising real value of benefits. New retirees have their benefits based on more recent wage histories, reflecting higher wage levels than earlier retirees. Hence, their benefits are higher as well. Real growth in benefit levels accounted for the remaining 19 percent in the 1976 outlay increase over 1975.

The Congressional Budget Office (CBO) has made a 5-year projection of program outlays based on the Second Concurrent Budget Resolution for FY 1976. The projections indicate a 69-percent increase in outlays from 1976 to 1981 (see Table 1).

Table 1.—CBO PATH B PROJECTIONS OF CURRENT SERVICES OUTLAYS FOR RETIREMENT AND DISABILITY PROGRAMS, 1975-81

[In billions of dollars]

Program	Estimate			Path B projections				
	1975	1976	TQ	1977	1978	1979	1980	1981
Social security (OASDI) _	65.3	72.7	19.9	84.5	93.5	102.6	111.7	120.7
Medicare (HI, SMI) _ _ _	14.8	17.5	4.8	20.5	23.7	27.0	30.5	34.5
Railroad retirement _ _ _	3.1	3.4	.9	3.7	3.8	4.0	4.1	4.2
Coal miners' benefits _ _ _	1.0	1.0	.4	1.3	1.4	1.5	1.5	1.5
Civil service retirement _	7.0	8.6	2.4	10.2	11.8	13.2	15.0	16.8
Military retirement _ _ _	6.2	7.4	2.0	8.6	9.7	10.6	11.7	12.8
SSI _ _ _ _ _	4.8	5.5	1.5	6.2	6.9	7.5	8.2	8.9
Medicaid (aged, blind and disabled part) _ _ _	5.1	6.2	1.6	7.1	8.0	8.8	9.7	10.5
VA compensation _ _ _ _ _	4.9	5.0	1.3	5.4	5.7	5.9	6.2	6.5
VA pensions _ _ _ _ _	2.7	3.0	.8	3.1	3.2	3.3	3.4	3.6
Food stamps (aged, blind and disabled part) _ _ _ _ _	.2	.3	.1	.3	.4	.4	.5	.5
Total _ _ _ _ _	115.1	130.6	35.7	150.9	168.1	184.8	202.5	220.5

Source: Unpublished tabulations, Congressional Budget Office.

At the request of the Senate Budget Committee, the CBO projected income transfer payments to the year 2000 to determine if any major shift should be expected in the proportion of gross national product transferred through Federal income transfer programs. The report ³ indicates that, assuming no major changes in current law, the current share of GNP (9.3 percent) devoted to income transfers will not change greatly over the rest of this century. Those contributory programs providing retirement benefits will rise relatively (from 6.8 percent to about 8 percent of GNP), but this growth would be offset by a decline in the noncontributory programs, since the latter programs count increased benefits from other programs against recipient income (see Table 2).

The retirement in the 21st century of people born after World War II will escalate the growth of social security. For example, in the year 2020, social security benefits will grow to \$472 billion under current law, or 6.6 percent of GNP, compared to \$179 billion and 4.9 percent in 2000. If "decoupled" to eliminate over-compensation for inflation, the figure in 2020 would be \$356 billion, or 5.0 percent of GNP. Thus, without decoupling, there will be substantial relative growth in social security benefits in the next century.

TAX EXPENDITURES

A number of tax expenditures are relevant to the retired and aged population. These provisions of tax law are listed below, together with estimates of the fiscal 1976 revenue losses associated with them:

TAX EXPENDITURE:

*Fiscal 1976 cost ¹
(millions)*

Exclusion of military disability pensions.....	\$85
Disability insurance benefits exclusion.....	280
OASI benefits for the aged exclusion.....	2, 940
Benefits for dependents and survivors exclusion.....	480
Exclusion of railroad retirement system benefits.....	180
Employer plans: exclusion of pension contributions and earnings.....	5, 740
Plans for the self-employed and others: exclusion of pension contributions.....	710
Exclusion of capital gains on house sales if over 65.....	10
Additional exemption if over 65.....	1, 250
Retirement income credit.....	70
Exclusion of veterans' disability compensation.....	550
Exclusion of veterans' pensions.....	35
Exclusion of capital gains at death.....	4, 550
Exclusion of interest on life insurance savings.....	1, 820
Exclusion of employer contribution to medical insurance premiums and medical care.....	3, 665
Deduction for medical care expenses.....	2, 020

¹ Estimated by the Treasury Department and the Joint Committee on Internal Revenue Taxation.

³ "Growth of Government Spending for Income Assistance: A Matter of Choice," Senate Budget Committee Print, Dec. 3, 1975.

Table 2.—CASELOADS AND COSTS OF FEDERAL INCOME ASSISTANCE PROGRAMS

[Constant 1975 dollars—in billions]

	Year 2000									
	Fiscal year 1975 ¹		Case 1—Current law		Case 2—Adjusted for cost of living		Case 3—Adjusted for income			
	Costs ²	Costs as percent of GNP ³	Family caseload (thou-sands)	Costs as percent of GNP ³	Family caseload (thou-sands)	Costs ²	Costs as percent of GNP ³	Family caseload (thou-sands)	Costs ²	Costs as percent of GNP ³
Social security and railroad retirement-----	66.7	4.4	31,411	4.9	31,411	166.2	4.5	31,411	166.2	4.5
Civil service and military retirement-----	13.2	.9	3,642	1.5	3,642	47.5	1.3	3,642	47.5	1.3
Unemployment insurance-----	49.1	.6	5,415	.3	5,415	16.0	.4	5,415	19.9	.5
Medicare—	10.6	.7	533,180	1.3	533,180	48.6	1.3	533,180	48.6	1.3
Part A-----	4.2	.3	533,273	.4	533,273	15.2	.4	533,273	15.2	.4
Part B-----										
Subtotal, contributory programs-----	103.8	6.8	-----	8.4	-----	293.5	7.9	-----	297.4	8.0

See footnote at end of table.

Table 2.—CASELOADS AND COSTS OF FEDERAL INCOME ASSISTANCE PROGRAMS—Continued

[Constant 1975 dollars—in billions]

	Year 2000					
	Fiscal year 1975 ¹		Case 1—Current law		Case 2—Adjusted for cost of living	
	Costs ²	Costs as percent of GNP ³	Family caseload (thou-sands)	Costs as percent of GNP ³	Family caseload (thou-sands)	Costs as percent of GNP ³
Veterans benefits-----	7.6	0.5	3,604	0.0	3,604	5.3
Supplemental security In-come-----	4.8	.3	1,405	.1	1,614	2.0
AFDC-----	9.7	.6	3,288	.1	3,815	8.8
Medicaid-----	12.4	.8	829,799	.7	831,713	26.3
Food stamps-----	14.6	.3	86,800	.2	86,885	5.9
Subtotal: Noncontrib-utary programs-----	39.1	2.6	-----	1.1	-----	48.3
Total: All programs ⁹ ----	142.9	9.3	(¹⁰)	9.4	(¹⁰)	341.8
						84.2
						381.6
						10.4

¹ Caseloads not available on a comparable basis for fiscal year 1975.

² Includes administrative expenses.

³ GNP for fiscal year 1975 with 5 percent unemployed is estimated to be \$1.529 billion; year 2000 GNP in 1975 dollars is estimated to be \$3.653 billion.

⁴ Adjusted to a 5-percent rate of unemployment. The actual unemployment insurance for fiscal year 1975 was estimated at \$13.5 billion with a 7.4-percent unemployment rate.

⁵ Eligible persons.

⁶ Zero due to rounding.

⁷ Includes commodity distribution.

⁸ Caseloads are average monthly households.

⁹ Components may not sum to total due to rounding.

¹⁰ Cannot be summed because of multiple program beneficiaries.

Source: "Growth of Government Spending for Income Assistance: A Matter of Choice," Senate Budget Committee Print, December 3, 1975.

While the revenue losses resulting from these tax expenditures cannot be added together accurately for technical reasons, the large magnitude of lost revenues is clear.

III. Relationships Among Retirement and Disability Programs

Trends for individual programs cannot be considered in a vacuum, since beneficiaries often receive benefits from more than one program. A policy decision on a social security matter, for example, will affect millions of welfare recipients and many people who also receive retirement checks under other systems.

Figures 1 and 2 illustrate graphically the relationship between the social security beneficiary group and those receiving SSI and VA pension benefits. Of the social security beneficiaries over age 65, 16 percent are also in one of the two assistance programs. About three-fourths of SSI recipients and over 80 percent of VA pensioners also receive social security benefits.

Social security (OASDI)
(31.7 million recipients)

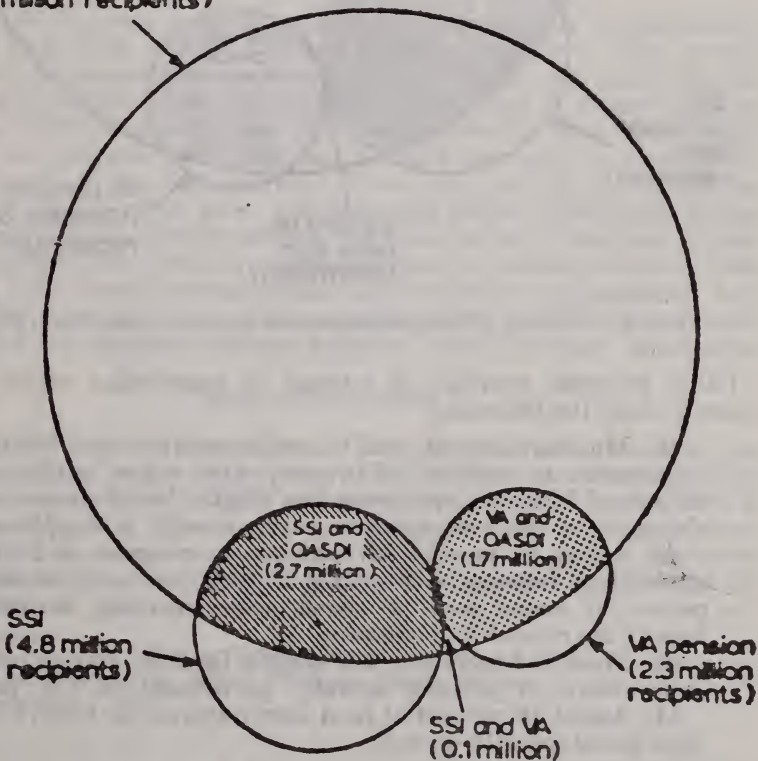


FIG. 1.—Overlaps in beneficiary groups, fiscal year 1975

Social security (OASDI)
(20.6 million aged
recipients)

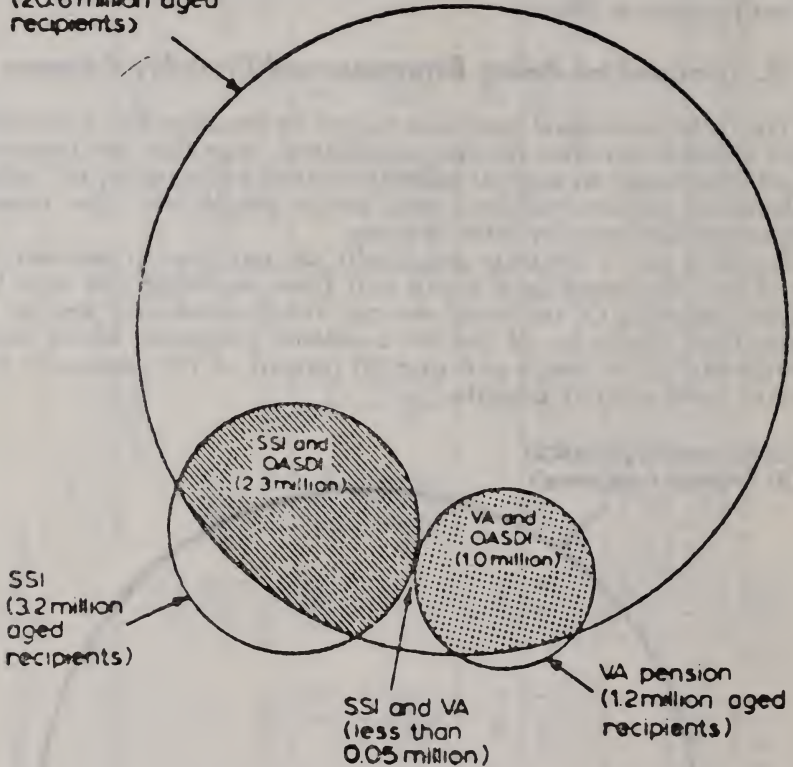


FIG. 2.—Overlaps in beneficiaries age 65 and over, fiscal year 1975

Other program overlaps of interest in considering major policy issues include the following:

(1) Medicare, an adjunct to social security, and Medicaid, a supplement to welfare aid, overlap each other, with about 17 percent of Medicaid recipients also eligible for Medicare benefits, although in some cases such dual coverage is supplementary.

(2) About 38 percent of civil service retirees, and virtually all military retirees, are entitled to social security benefits—2.5 percent of social security beneficiaries receiving the minimum benefit are retired civil servants.

(3) Most SSI recipients are eligible for food stamps, although only about 50 percent actually participate in the program.

(4) About 36 percent of food stamp recipients receive benefits from social security as well.

Thus, legislative changes in any one of these programs may affect the recipients of several other programs. Retirement policy should be considered for all of these related programs as a system in order to avoid unanticipated consequences detrimental to a beneficiary group or a particular policy goal.

IV. Major Policy Issues

A. FINANCING SOCIAL SECURITY IN THE SHORT RUN

THE BACKGROUND

Fund deficits

Benefit payments under the social security old-age and survivors and disability insurance programs (OASDI) will exceed receipts of the related trust funds by some \$2.9 billion in fiscal 1976 and by about \$1.7 billion in the Transition Quarter. Unless legislative action is taken, this deficit will exceed \$5 billion in fiscal 1977 under either the economic assumptions used in the President's budget or the Path B assumptions used in CBO's "Five-Year Budget Projections, Fiscal Years 1977-81." Predictions of the extent to which trust fund reserves will be reduced by deficits in later years depend upon the economic assumptions used. The CBO projection shows reserves dropping to \$28 billion in 1980 (down from \$48 billion in 1975) but rising again in 1981.¹

Causes

Historically, receipts from payroll taxes for OASDI have exceeded benefit payments, except during economic downturns. The present excess of payments over receipts is the result of rapid inflation combined with a deep recession. Under the provisions of amendments to the Social Security Act which became effective in 1972, benefit payments are automatically adjusted upward annually to compensate for increases in the cost of living. Prices rose rapidly in 1974 as the result of oil and food price increases and other inflationary forces. Simultaneously, business activity deteriorated with resultant unemployment and reductions in personal income. As a consequence of these events, total benefit payments increased rapidly as adjustments were made for price increases, while receipts of the OASDI trust funds, restricted by sluggish business activity, failed to reach anticipated levels.

Extent of the problem

Table 3 illustrates the problem.¹ The report of the trustees of the social security fund issued in May 1975, forecast a more rapid decline in the reserves of the OASDI funds than that indicated by the Path B section of Table 3. The trustees predicted that, on the basis of more pessimistic economic assumptions, both the old-age and survivors insurance and the disability insurance funds would be depleted by about 1980 or 1981.

¹ Testimony of C. William Fischer, Assistant Director of the Congressional Budget Office, before the House Ways and Means Subcommittee on Social Security, February 3, 1976.

Table 3.—PROJECTIONS OF THE RECEIPTS AND DISBURSEMENTS¹ OF OASDI TRUST FUNDS, 1975-1981

[Fiscal years; in billions of dollars]

	1975	1976	TQ	1977	1978	1979	1980	1981
Path A:								
Receipts-----	65.7	69.8	18.2	82.5	95.9	108.6	122.1	139.5
Disbursements-----	63.7	72.7	19.9	83.9	91.7	102.4	112.5	123.1
Annual surplus-----	+2.0	-2.9	-1.7	-1.4	+4.2	+6.2	+9.6	+16.4
Reserve (end of year)-----	48.2	45.3	43.6	42.2	46.4	52.6	62.2	78.6
Path B:								
Receipts-----	65.7	69.8	18.2	79.3	89.4	98.9	109.0	122.6
Disbursements-----	63.7	72.7	19.9	84.5	93.5	102.6	111.7	120.7
Annual surplus-----	+2.0	-2.9	-1.7	-5.2	-4.1	-3.7	-2.7	+1.9
Reserve (end of year)-----	48.2	45.3	43.6	38.4	34.3	30.6	27.9	29.8

¹ Excludes offsetting receipts.

NOTE: These projections do not constitute a CBO estimate of the most likely path of economic activity but are only 2 of many possible paths that the economy might follow; they are not predictions or targets.

Economic assumptions:

PATH A: The rate of increase in real GNP would be 7 percent in 1977 and average 6 percent over the 5-year period. The unemployment rate would drop to 4.5 percent in 1980

and 1981. Inflation would remain at rates of 6-7 percent. The average annual increase in current-dollar GNP would be 13 percent.

PATH B: The rate of increase in real GNP would dip below 4 percent in 1977 and average about 5 percent over the 5-year period. The unemployment rate would be just below 6 percent in 1981. Inflation rates would be somewhat lower than under Path A, particularly in 1980 and 1981. Current-dollar GNP would increase at 11 percent average annual rate.

Corrective action

From 1961 to 1972, the ratio of reserves to annual benefits declined from 133 percent to 113 percent. Since then, it has declined sharply to 60 percent. If Congress determines that OASDI trust fund reserves should be maintained at higher levels because of the inherent uncertainties in economic projections, legislative action can be taken to increase receipts, selectively restrict benefit payments, or both.

POSSIBLE REVENUE SOLUTIONS TO THE SHORT-RUN PROBLEM

Alternatives

Alternative ways of increasing OASDI trust fund receipts include—

- (1) increasing the tax rate applicable to the employee and the employer;
- (2) increasing the tax rate applicable to the employer only;
- (3) increasing the maximum taxable earnings for both employees and employers;
- (4) increasing the maximum taxable earnings for the employer only;
- (5) a transfer of part of the Medicare payroll tax to the OASDI funds;
- (6) a regular appropriation from general revenues in amounts sufficient to maintain the fund reserves at the desired level;
- (7) a one-time loan or grant from general revenue in an amount sufficient to insure that the fund reserves are maintained at the desired level; or
- (8) a levy of an excise tax on some activity or commodity such as energy with the proceeds earmarked for the OASDI funds.

Present tax structure

The present social security tax structure involves the following payroll tax rates applicable both to the employee and the employer on the first \$15,300 in wages and salaries:

	<i>Percent</i>
OASI.....	4.375
DI.....	.575
Medicare.....	.900
Total.....	5.850

Since the tax is paid by both the employee and the employer, the combined rate is 11.7 percent.

The OASI and DI rates (4.95 percent combined on both employee and employer) are fixed by present law until the year 2011 when the combined rate will increase by 1 percent for both employee and employer. The taxable wage base is adjusted upward by the rise in average wages each time an adjustment in the benefit structure results from an increase in the cost of living. This automatic adjustment is expected to increase the wage base from the present \$15,300 to \$16,500 on January 1, 1977.

Increase tax rates

One of the alternatives for increasing revenues for the OASI program is to increase the tax rate applicable to both the employer and the employee. The President's 1977 fiscal year budget proposes a tax rate increase of 0.3 percent on both employers and employees effective January 1, 1977, raising the total social security payroll tax from 11.7 percent to 12.3 percent. According to the President's budget, the proposed rate increase would generate \$3.3 billion in additional revenue in the nine months of the 1977 fiscal year for which it would be effective. Social security receipts would exceed outlays in fiscal years 1977 through 1981 if this rate increase and recommended benefit adjustments are adopted. The recommended benefit adjustments are discussed in the next section of this paper.

A tax rate increase distributes the burden proportionately on all taxpayers who pay on less than the maximum taxable earnings, avoids borrowings or grants from outside sources and is not necessarily inconsistent with long-run remedies. On the other hand, payroll tax rates are already high (more than half the U.S. households pay more social security taxes than personal income taxes), and the burden falls relatively harder on low-income salaried and wage employees. Half the payroll taxes collected in 1977 will relate to the wages of persons earning less than \$7,500 a year. Others argue that the regressivity of the tax is more than compensated for by the relatively higher benefits enjoyed by low-income people upon retirement.

Increase tax base

Another alternative for increasing the OASDI revenues is to increase the amount of the wage or salary subject to tax. This would cause higher income people to bear more of the burden of financing the system. It is argued that the higher income individuals have greater ability to pay and, in any case, would be paying no greater portion of their income in social security taxes than do lower income people. On the other hand, since benefits are computed on the basis of average wages included in computing the tax, future benefits would be higher, although not by enough to increase the long-run deficit (to be discussed later). It is also argued that increasing the burden on higher income individuals could have an adverse effect on capital formation.

Applying increases to employer only

Eliminating the ceiling on the wage base for purposes of computing the employers' tax, but retaining the ceiling for the employees' tax, could eliminate the objection that the higher wage base would create a long-run problem of increasing benefits. It would also be possible to increase the tax rate on the employer without increasing the employee's rate. However, either of these approaches would sharply increase the employer's total tax, and the increase might eventually be passed on to employees through smaller or less frequent wage increases or through a shift to labor-saving machinery.

ECONOMIC IMPLICATIONS OF THE PAYROLL TAX

The payroll tax has a powerful impact on inflation and unemployment. While it is thought that, in the long run, this tax is borne by wage earners, its short run effect is partly to raise prices.

Half of the payroll tax is paid by employers. But employers treat this tax as a part of unit labor costs, and pass it on to consumers in the form of higher prices. Moreover, there is evidence that the tax is passed on with whatever markup is traditional in each industry. Thus, higher payroll taxes cause employers to raise prices, and this contributes to inflation in the short run.

Since the tax removes purchasing power from private hands, it causes sales, and hence output, to fall just as any other tax increase would. But the reduction in sales is larger than would be the case for an equivalent reduction in the income tax. This is because the payroll tax, in addition to reducing private funds, causes prices to rise, and the increase in prices reduces the purchasing power of the funds that remain in private hands. For this reason, it is felt that sales would fall more due to an increase in the employer payroll tax than they would if the income tax were increased by an equivalent amount.

The reduction in demand would remove some price pressure from private markets. This would offset part of the inflationary effect mentioned above. At present levels of unemployment, it is estimated that these two price effects might offset each other after about 5 years. This happens in the case where the effect of the payroll tax increase on unemployment is twice as strong per dollar as the effect of an increase in the income tax. Because of this sizable effect on demand, markets can cause prices to fall by as much as they are increased due to the effect of the payroll tax on labor costs.

Since the payroll tax has adverse effects on unemployment and no beneficial effects on inflation, the other methods that are available for financing the Social Security System (described below) deserve consideration at this time.

Use of medicare tax in OASDI trust funds

The medicare program is funded in part by a 0.9 percent payroll tax on employees and employers. It is scheduled to rise to 1.1 percent on January 1, 1978. The medicare program does not face the short-run deficit problem that the cash benefit programs do. Even during the current recession, medicare trust fund reserves will rise by \$3.9 billion from 1976 to 1977. This situation prompted the 1975 Social Security Advisory Council to propose shifting part of the medicare tax to the OASDI trust funds. Advocates of expanded health insurance oppose this idea, wanting to retain these funds for health care financing.

General revenue support or Treasury borrowing

It would be possible to make up the short-term fund deficits by authorizing borrowing from the Treasury or annual appropriations from general revenues, or by making a one-time grant or loan from general revenues in an amount sufficient to cover the total of the

anticipated short-run deficits. Either of these methods would avoid permanent benefit increases and would make the source of the additional fund support less regressive than would a rate increase. Federal funds could be justified as paying for certain welfare features of the system, such as the minimum floor on benefits. Further justification might be the inability of planners to anticipate the severity of the present recession. On the other hand, such "temporary" measures could become permanent; they would violate social security's "earned right" principle and would be a basic change in the self-financing structure of the program with its built-in restraints. It is argued that the Social Security System should be supported directly by those who are to benefit from it and that the support should be obvious.

Another "earmarked" excise tax

It would be possible to impose an excise tax on some service or commodity such as energy and " earmark " the proceeds for the OASDI funds. Such a financing method would avoid the argument that the payroll tax is regressive but, depending on the tax base, might create another instance of regressive taxation. The problem of linked long-run benefit increases would not be present, but the objections to general fund financing would also apply to this type of financing. It should also be borne in mind that a wide variety of redistributive and economic effects can result from excise taxes as from other taxes. Also, the budgetary inflexibility associated with earmarking funds for special purposes is an argument against this approach.

POSSIBLE BENEFIT ADJUSTMENT SOLUTIONS TO THE SHORT-RUN PROBLEM

Alternatives

Alternative ways of reducing benefit payments to reduce or avoid OASDI deficits include—

- (1) placing a "cap" on cost-of-living adjustments in benefits;
- (2) incorporating a "needs" test for secondary benefits;
- (3) phasing out the minimum benefit payment;
- (4) phasing out student benefits;
- (5) converting the "retirement" test from a monthly to an annual income test; or
- (6) eliminating the lump sum benefit option.

It is doubtful if benefit changes could be large enough or accomplished soon enough to solve the short-range problem all by themselves, however.

"Capping" cost-of-living adjustments

In his 1976 budget request last year, the President recommended placing a limit of 5 percent on the fiscal 1976 adjustments in all income security programs tied to increases in the consumer price index. This recommendation did not meet with Congressional favor. The objection to limiting cost-of-living adjustments for OASDI benefits is that these beneficiaries are hit hardest by inflation and are least able to take steps to offset the real income loss. "Capping" of benefits for a couple of years, if not later made up and if in an appropriate amount, could permanently solve the short-run problem at the expense of permanently lower benefits.

"Needs" testing for secondary beneficiaries

It has been suggested that benefits should be made available to the dependents of the primary beneficiary (the worker on whose earnings the social security tax was paid) only upon a showing of need or actual financial dependence on the primary beneficiary. The annual combined saving in benefit payments from this alternative and the phasing out of the minimum benefits alternative discussed below would gradually increase over time to about \$1.2 billion in 1981. The objection to "needs" testing is that it would turn the Social Security System into a welfare program and introduce new administrative complexities into the system.

Phasing out minimum benefit

At present, any individual who has earned as little as \$50 a quarter in covered employment for the number of quarters needed to retire is entitled to a \$101.40 monthly benefit, whereas, an individual who has worked all his life at the Federal minimum wage would receive a \$196 monthly benefit. Since the minimum benefit frequently provides a "windfall" for persons who were only infrequently employed or who were fully employed under another retirement system it could be phased out by eliminating it for future retirees. The objection to this alternative would be that, for some beneficiaries who cannot qualify for welfare, a major source of income would be reduced.

Phasing out student benefits

The President's 1977 budget proposes to phase out over a 4-year period the provision of present law which entitles a child of a deceased worker to receive benefits until the age 22, without proof of need, if he or she attends school. It is argued that it is preferable to have needy students rely on programs specifically designed to aid students. However, about 20 percent of students now receiving student aid also receive social security benefits, so these two sources of aid are supplementary, not complete substitutes.

Converting the retirement test to an annual basis

The President's budget for 1977 proposes legislation to eliminate the present practice whereby some beneficiaries concentrate large annual earnings into one or two months during which they "go off" social security but still collect full benefits for the remainder of the year. It can be argued that converting to an annual test will discourage some beneficiaries from working at all. The funds will benefit by making less payments.

Prohibiting the lump-sum benefit option

The President's 1977 budget proposes elimination of the present option granted to people retiring after minimum retirement age to take on an annuity based on either actual age, or a lesser annuity, plus a lump sum equal to all monthly payments between minimum retirement age and the age of actual retirement. The justification presented for this amendment is that the individual should take the higher

monthly payments and that the initial lump sum drain on the OASI fund would be eliminated. It can be argued that the lump sum option is useful to the retired person in adjusting to retirement. The proposal would result in higher long-term benefits.

DELAY IN OR AVOIDANCE OF CORRECTIVE ACTION ON THE SHORT-RUN PROBLEM

It is being argued that action to correct the short-run problem is not necessary now because the danger of exhausting the funds appears less acute, that additional time is needed to be sure that any short-run solution is consistent with or an integral part of the solution to the long-run problem, and that additional taxes under present economic conditions can add to inflation and interfere with recovery from the recession. It is also argued that the prospective future deficits will not exhaust the reserves until the long-range funding problem begins to take effect after 1981, by which time a long-range solution must be in place. The arguments against this delay strategy are that economic projections are not sufficiently reliable to insure that the reserves will not be prematurely exhausted and that, in any case, the longer an increase in revenues is delayed, the larger must be the eventual increase. On the other hand, it can be argued that benefits are really paid from current income, that rates should be adjusted from year to year, and that the reserves are not needed except to maintain the appearance of a funded annuity system. The President's proposal would build up reserves to \$73 billion by 1981, compared to annual benefit payments of \$122 billion.

B. LONG-RUN SOCIAL SECURITY ISSUES: DECOUPLING AND FINANCING

The long-range social security problem is the result of (1) demographic factors caused by the post World War II "baby boom" and an unanticipated rapid decline in the birth rate in this country in the late 1960's and early 1970's, and (2) a flaw in the statutory benefit formula which overadjusts benefits for the effects of price inflation.

Demographics

The Brookings Institution's publication, "Setting National Priorities, The 1976 Budget," indicates that there are now about 3.2 workers in the labor force for every beneficiary, but that in 70 years there will be only slightly more than two workers per beneficiary. This demographic change will, of itself, force a change in the tax structure, or in benefits, or both.

The decoupling issue

The flaw in the rate structure is frequently referred to as a problem requiring "decoupling" and accounts for about half of the long-range deficit. The error in the social security law is that, despite the fact that inflation operates to increase the wage base on which benefits are calculated, the benefit formula applied to the higher wage base also contains an adjustment for CPI increases. The result is that the formula overcompensates for the inflation-caused increases occurring *while the worker is in the labor force*. If uncorrected, this error will cause some workers to receive more in periodic benefits than they receive in wages

before retirement. The issue is not related to the upward adjustment of benefits that the law provides for cost-of-living increases which occur after retirement.

Corrective legislation, which is necessarily technical in nature, could take any of several approaches. The legislation the Administration will propose is intended to have the effect of maintaining for the average retiree the same ratio of benefits to pre-retirement income as is provided for the average person retiring today. Correction of this effect in the social security law will eliminate about half of the long-term deficit in the OASDI system.

Overcoming the remaining long-term deficit

To eliminate the rest of the long-term deficit, a modification of the tax structure, or the benefit structure, or both, will be required. Care must be exercised to insure that changes intended to overcome the long-term problem do not make the short-term problem unmanageable. Similarly, the changes made to deal with the short-term problem must be carefully evaluated for their long-term impacts on the system.

As to the burden on future workers of supporting a greater proportion of elderly persons, it has been pointed out that the dependency ratio for the combination of children and aged will be lower in all future years than the same ratio for the present population distribution, assuming no new "baby boom" develops. The following chart illustrates this point.

Year	Numbers of—			Number dependent per 100 workers		
	Aged	Workers	Children	Aged	Children	Total
1973-----	21, 916	117, 956	79, 665	18. 6	67. 5	86. 1
2000-----	30, 214	157, 038	76, 333	19. 2	48. 6	67. 8
2030-----	51, 227	167, 873	80, 768	31. 1	49. 1	80. 2
2050-----	49, 352	173, 843	84, 462	28. 4	48. 6	77. 0

Source: House Select Committee on Aging Hearings, Apr. 29, 1975, p. 11.

Since the technical work of developing benefit and revenue alternatives for solution of the demographic-related portion of the long-term financing problem is not yet far advanced, no attempt has been made here to deal with such alternatives, but it is necessary to remember that the longer the delay before solutions are found, the more costly will be the solutions when put in place.

C. PROTECTION AGAINST CATASTROPHIC HEALTH CARE COSTS

The present system of health insurance fails to provide for protection against catastrophic health care expenses, such as extended hospitalization, at a reasonable cost. Those who favor some form of federalized catastrophic insurance argue that protection against catastrophic illnesses add only marginally to health care costs due to their rarity.¹

¹ The illnesses most often associated with lengthy or repeated hospitalization include kidney disease, premature birth, respiratory tuberculosis, cancer, diabetes, chronic brain disorders, psychosis, nervous system disease, heart disease or strokes, various types of fractures, head injuries, and burns.

Those opposing it stress the possible inflationary effect that the introduction of a national catastrophic insurance program could have. In addition, such protection may establish strong incentives for costly high-technology care in lieu of greater investment in preventive health services.

Several plans have been proposed to provide protection against catastrophic medical costs. In any of these catastrophic insurance programs the important variables that would influence the budget impact include the level of protection provided, the extent to which it is tax—as opposed to premium—financed, and the extent to which the program imposes cost controls.

President's proposed legislation

Under the President's proposed legislation to limit expenses for Medicare beneficiaries, catastrophic protection would be achieved by limiting beneficiary cost-sharing to \$500 annually for covered services under hospital insurance (HI) and \$250 annually for services covered by supplementary medical insurance (SMI).

The limits would not apply to services which are excluded from reimbursement under current legislation. For example, beneficiaries would continue to be responsible for that portion of physician fees which exceed Medicare reasonable charge levels. Out-of-pocket expenditures for payment of "excess charge" physician fees would not count toward satisfying the \$250 SMI deductible. Similarly, expenditures for non-covered services (such as drugs, eyeglasses, and hearing aids) would also be excluded.

If the President's proposal is accepted in its entirety, including the 10 percent HI co-insurance, approximately 1 million out of the 5.9 million persons using HI-covered services in 1977 will benefit from the \$500 cap. HEW estimates the cost of providing this protection under HI at \$0.9 to \$1.1 billion in fiscal 1977. (\$145 million of this amount represents a transfer of costs from Medicaid to Medicare.)

Alternatively, if the "catastrophic" protection proposals are implemented without the new co-insurance, a much smaller number of persons will benefit from the expenditure caps. Under current law, a beneficiary is responsible for an HI deductible equal to the average cost of one day's hospitalization. After that, Medicare pays the full cost of HI-covered services through the 60th day of hospitalization, after which the beneficiary pays one-fourth of the deductible until the 91st day, and one-half of the cost from the 91st day until coverage is exhausted.

Therefore, under current cost-sharing provisions, a Medicare recipient would have to be hospitalized for 73 days before benefitting from the \$500 cap. Fifty thousand recipients would qualify under current law. Approximately 95 percent of Medicare hospital stays end at least 2 weeks before the 61st day when co-insurance now becomes operative. Only 4 percent exceed 61 days.

In fiscal 1977, the cost of eliminating all hospital coverage after the 60th day, excluding the first day deductible under current law, would be approximately \$208 million. Thus, \$712 million (77 percent) of the President's \$920 million HI "catastrophic" benefits is estimated to result from his proposed 10-percent cost sharing.

The Administration estimates that the \$250 SMI cap will assist 2 million of the 14.2 million beneficiaries using SMI-covered services in 1977 at a cost of \$208 million. This proposal will chiefly benefit the disabled and chronic renal disease beneficiaries whose per capita SMI costs are significantly higher than those of the aged.

For the general class of Medicare recipients, the Administration's SMI proposal fails to address their most significant burden from non-hospital costs—physician fees that exceed Medicare's reasonable charge level and must be paid directly by the patient. In 1975, of the \$2.7 billion SMI charges submitted directly by the beneficiaries (i.e., cases where the physician refused "assignment"), 16.6 percent of billed charges, or \$448 million, was denied as excessive. Seventy-seven percent of all claims were reduced, the reductions averaging \$13.00.

CATASTROPHIC HEALTH INSURANCE AND MEDICAL ASSISTANCE REFORM ACT OF 1975 (S. 2470)

S. 2470 is a three-part bill sponsored by Senator Long. It is designed to meet the health care financing needs of all Americans with large or catastrophic health care costs and to restructure the Medicaid programs to provide basic health care for all low-income individuals. The bill provides for a catastrophic health insurance program for all U.S. residents through a *federally administered* public plan for the unemployed, welfare recipients, the aged, and persons who do not opt for private insurance coverage, or a *privately administered plan* allowed as an option for employers and the self-employed. Benefits of the program would be similar to those currently covered under Medicare. These benefits would begin after the beneficiary had incurred medical expenses of \$2,000 or had been hospitalized for 60 days. The catastrophic program would be financed through a 1-percent payroll tax, offset by a 50-percent tax credit for all contributing employers. S. 2470 would replace the existing Medicaid program with a uniform, national program of medical benefits for all low-income individuals and families whether they are on welfare or not.

The estimated cost of the catastrophic program is from \$7.5 to \$8.5 billion for fiscal 1977. This would be financed by the payroll tax. Approximately \$2.6 billion is now being spent under current law for Medicare and Medicaid to pay for services that would be covered under the Long-Ribicoff bill. Medicaid reform would cost about \$8 billion more than under current law.

D. FEDERAL SERVICE RETIREMENT AND DISABILITY

CIVIL SERVICE RETIREMENT

The current civil service retirement system provides for optional retirement at age 55 with 30 years of service, at age 60 with 20 years, or at age 62 with 5 years. The lifetime base annuity is computed by using the average salary for the 3 years of highest earnings. The annuity increases as a percent of average salary depending on length of service—7.5 percent with 5 years of service, 36.25 percent with 20 years, 56.25 with 30 years. The maximum benefit is 80 percent after 42 years of service.

Basic annuities are indexed to increase whenever the consumer price index rises by 3 percent and remains at that level for 3 consecutive months. The size of the cost-of-living adjustment is determined by the percent increase in the consumer price index between the last base month and the highest-cost month in the 3-month period. The increase becomes effective 3 months later. An extra percentage point—commonly referred to as the “1 percent kicker”—is added to compensate for a lag between price increases and the effective dates of adjustments.

Two other provisions in law for determining the size of the first post-retirement adjustment also increase the annuity above considerations of salary and service alone:

First, the initial cost-of-living adjustment is *not* prorated to reflect the time an employee has actually been in retired status since the last increase. Consequently, an employee retiring the day before the effective date of the adjustment receives the full increase even though there has been virtually no decrease in purchasing power for that retiree.

Second, an employee is entitled to receive no less than the most recent cost-of-living increase predating his retirement. This is commonly referred to as the “look-back provision.”

The combined effects of the “1 percent kicker” and the first post-retirement adjustment provisions overcompensate for inflation over the 20-year average life span for civilian retirees. Other Federal programs which are indexed for price changes do not provide for such frequent or liberal adjustments. Social security payments are adjusted once a year with a 5-month lag; food stamps are indexed twice a year with a 1-month lag; white-collar civilian and military pay are adjusted once a year with a 6-month lag.

From 1975 to 1981, outlays for civil service retirement and disability are expected to more than double—rising from \$7.0 billion in 1975 to \$16.5 billion under CBO Path B growth rate.

During the 5 years between 1977 and 1981, projected cumulative outlays would total nearly \$67 billion, a cumulative increase of \$21 billion over an annual straight-line projection of the Transition Quarter estimate. The additional outlays are attributable largely to a 24-percent increase in the number of beneficiaries and to cost-of-living adjustments. The remainder of the increase would be due to changes in employee earning rates.

Elimination of the so-called “1 percent kicker” in fiscal 1977 would reduce outlays for civil service retirement by \$93 million in the first year and accelerate to an annual reduction of nearly \$1 billion by 1981 using CBO’s fast-growth assumptions.

Income to the civil service retirement fund is treated as budget authority (permanent, indefinite) and comes from three primary sources:

(1) *Employer (agency) and employee contributions.* These contributions, set by statute, are now 14 percent of pay and are divided equally between employer and employee. The contribution level is intended to cover the actuarial or “normal cost” of benefits for a new retiree who has been employed by the Government for the full number of required service years. In practice, however, the contribution level does not cover full cost because it excludes anticipated increases in cost-of-living, salaries, and interest rates.

(2) *Extra Federal contribution*, which includes two parts: (a) payments for 30-year amortization of any increased liability created by pay raises, benefit liberalizations, or extensions of coverage; and (b) payments equivalent to an increasing percentage of interest on unfunded liability which was initiated in 1971 at 10 percent of interest, and scheduled to reach 70 percent in fiscal 1977 and 100 percent by fiscal 1980.

(3) *Interest earned on balances in the fund which are invested in U.S. securities.* Balances in the retirement fund accumulate from excess income (including interest earned) over outgo for payment of beneficiaries. Balances increased from \$22.4 billion on June 30, 1971, (the year before in-lieu-of-interest payments) to \$38.7 billion on June 30, 1975. Assuming no change in benefits or current provision for indexation, fund balances are projected to reach \$80.7 billion by 1981 under CBO's fast-growth assumption. If the "1 percent kicker" were eliminated, the balance by 1981 would increase to \$82.4 billion as a result of a lower level of outlays over the 5-year period.

After 1981, the balances should continue to increase at a more level rate and the fund should be able to meet its requirements—so long as new employees continue to enroll in the system and salary and interest rates increase in the long run slightly faster than the cost-of-living. By 1981 annual income from the fund will exceed outgo by about \$9.0 billion, or \$9.6 billion with elimination of the "1 percent kicker".

MILITARY RETIREMENT

The military retirement system pays a lifetime annuity which can begin after 20 years of service. The annuity after 20 years is 50 percent of basic pay at the time of retirement, rising to 75 percent with 30 years of service. Military personnel do not contribute directly to the retirement system. The benefits, and the lack of an offsetting contribution, make military retirement very expensive. In fiscal 1976, the Defense Department will spend about \$7.4 billion—some 8 percent of all defense outlays—on retirement. Costs will increase to \$12.8 billion by fiscal 1981 and represent 9 percent of all defense outlays.

Military personnel who leave service with less than 20 years receive no pension. As a result, the retirement system provides virtually no incentive for younger personnel to reenlist after their first tour of duty when retirement still is as much as 16 years in the future. As a result, most recruits leave after their first tour. Of those who reenlist after that tour, most remain in service for a full 20 years. Few personnel remain in service after 20 years, however. Thus, the system is not designed to encourage younger personnel to remain in service so that the Defense Establishment can obtain a return on the heavy investment in their training. Nor does the system seem to encourage many highly experienced personnel to stay on active duty after 20 years.

The Retirement Modernization Act, which is currently before Congress, is designed to reduce the number of 20-year retirements slightly and increase the number of reenlistments. The plan would provide limited retirement benefits after 10 years of service which makes first reenlistments more attractive. It would reduce the basic annuity after 20 years of service from 50 percent to 35 percent for the first 10 years of retirement, which encourages experienced personnel to stay on active duty.

The plan would increase military retirement costs during its first few years of operation because of increased benefits for personnel who retired after 10 years, but the Defense Department estimates that the plan would cut retirement costs by \$800 million in current dollars by the year 2000. Other plans to save even more funds have been proposed.

Military pension payments are indexed to the consumer price index on essentially the same basis as civil service pensions and include the "1 percent kicker" designed to compensate for lags between price increases and annuity increase.

The same arguments that are made against the "kicker" for civil service pensions apply to military annuities. Since the clause became effective, there have been nine increases which have increased annuities by 63 percent. During that time, the cost of living has increased by only 50 percent. The Defense Department would save \$90 million in fiscal 1977 if the kicker were eliminated and more than \$600 million in fiscal 1981.

Without the 1 percent bonus, military retirees would be slightly undercompensated for price increases because of the lag between price and annuity increases. However, there are other ways to cure the problem. For instance, a lump sum could be added to the first check after a consumer price adjustment was made. In an interim report, the Defense Manpower Commission (DMC) has proposed a way of calculating the required lump sum payment. Adopting the DMC lump sum payment would dramatically affect savings. Eliminating the kicker and adopting the DMC lump sum payment would actually increase military retirement costs in fiscal 1977 by over \$300 million dollars. In fact, costs would increase in 3 of the 5 years from 1977 to 1981. Of course, in the long run eliminating the kicker and adopting the DMC lump sum payment would still save significant amounts.

Unlike Federal, State and local civil servants and many employees of private firms, military personnel make no cash contribution toward their retirement system. Several methods for initiating a contributory system have been proposed, each carrying savings to the Federal Government.

It is not clear whether imposing a contributory system on the present military retirement system is desirable. By cutting the pay, in effect, of personnel who stay in the service until retirement, a contributory plan might reduce the number of 20-year careerists; such a reduction is probably desirable since 20-year careerists are expensive. But a contributory plan may reduce 20-year careerists by cutting first-term reenlistments; this is probably undesirable since the military loses members in whom it has recently made substantial training investments. Because of these consequences, a contributory retirement program should probably be considered along with benefit reforms such as the Retirement Modernization Act. These benefit reforms can incorporate the desirable features of contributory retirement while offsetting undesirable ones.

This report has examined two levels of contribution toward military retirement—a 7-percent individual contribution, which is the level at which Federal civil servants contribute to their retirement fund, and a 10-percent contribution which might be more appropriate in view of the more generous retirement benefits in military service.

Even a 10-percent contribution would fall short of fully funding military retirement. An enlisted man retiring as an E-7 after 20 years of service would have had to contribute 80 percent of his basic pay each year—or 40 percent if the contribution were matched by the Defense Department—to fully fund his retirement if one assumes only a 3-percent annual inflation rate. An officer retiring as an O-6 after 30 years would have had to contribute about 60 percent of his base pay throughout his career, again assuming 3 percent inflation. These percents do *not* of course imply that Defense would have to set aside 60 to 80 percent of basic pay to fully fund military retirement since many military members do not stay until retirement.

Consistency with the Federal Civil Service System would suggest a compulsory contribution for military personnel. However, civil servants are not covered by social security, which is one reason their retirement payments are compulsory. Military personnel, on the other hand, are required to participate in social security. As long as that requirement remains in effect, there would be an argument for putting contributions for military personnel on a voluntary basis.

A voluntary option would avoid deductions from junior personnel who did not wish to participate. Under a compulsory option these deductions, even though they would eventually be refunded if the person left before retirement, might make recruiting more difficult by lowering starting take-home pay. Also the prospect of a large lump sum refund if one chooses not to reenlist may cut down on reenlistments. On the other hand, a voluntary option has the major disadvantage that personnel who elect not to participate in the first years they are in the military, but who later are considering a career and wish to participate, would be faced with a large make-up payment which might cause them to decide against a career. Some advantages of both options might be obtained by making the system voluntary up to 5 years of service and compulsory thereafter.

All options assume that military members would still be required to participate in social security. This assumption would make the new military retirement system different from its civil service counterpart, whose members are exempt from social security, but not different from most private pension plans. Keeping the military in social security would avoid any adverse short-run effect on funding of the Social Security System. Taking the military out of social security would reduce the system's current income by almost \$2 billion per year but would not reduce benefit payments for many years. All options also assume that military contributions would be taxable, as is now the case for civil service contributions.

Costs

Table 1 below indicates savings to the government under the 7 percent and 10 percent options and, within each, under a voluntary and compulsory option. Savings under the voluntary options assume "perfect foresight" (i.e., only those who eventually retire choose to participate). Savings under the compulsory options are based on estimates adjusted for inflation.

Table 1 reflects all major savings in fiscal 1977-1981, but savings may change in the longer run. By reducing the take-home pay of those continuing to retirement, a contributory retirement system should reduce the numbers who stay until retirement. Fewer personnel con-

tinuing to retirement would eventually save money by reducing the costs of military retirement. On the other hand, higher losses will increase the costs of recruiting and training. Even though neither of these increases or decreases in costs are included in the savings in Table 1, they should have little effect on costs in fiscal 1977-1981.

Table 1.—SAVINGS UNDER MILITARY RETIREMENT OPTIONS

[In millions of dollars; Path B inflation ¹]

	Fiscal year—				
	1977	1978	1979	1980	1981
Military retirement (current policies)-----	8,600	9,650	10,550	11,700	12,800
Eliminate 1 percent kicker----	-90	-200	-350	-500	-650
Contributory retirement:					
Voluntary, 7 percent-----	-700	-750	-850	-900	-950
Voluntary, 10 percent-----	-1,000	-1,100	-1,200	-1,250	-1,350
Compulsory, 7 percent----	-1,200	-1,150	-1,100	-1,150	-1,150
Compulsory, 10 percent--	-1,700	-1,650	-1,600	-1,650	-1,650

¹ Path B inflation percentages as follows:

	Fiscal year—				
	1977	1978	1979	1980	1981
CPI-----	6.7	5.0	5.9	4.5	4.8
Wages-----	12.0	8.8	8.3	6.9	6.9

Source: Congressional Budget Office.

The savings in Table 1 do not consider tax effects. Currently, almost all military annuities are taxable. But if military contributions are taxed (as is assumed in Table 1), then annuity payments up to the amount of the contribution should be tax free. Thus, some fraction of the savings, perhaps 20 percent or so, would eventually be lost to the government through reduced tax revenue. But there would be little effect in the first few years and hence little effect on the savings in table 1.

E. OTHER PENDING LEGISLATION

INTRODUCTION

Congress has before it several proposals for reforms in veterans' pensions, the black lung disability program and supplemental security income. Another bill would increase the retirement income tax credit.

This section discusses the background and budgetary impact of each of the proposals for change.

VETERANS AND SURVIVORS PENSIONS

Legislation

VETERANS AND SURVIVORS PENSION REFORM ACT (S. 2635)

Under current law a needy, wartime veteran is eligible for pension benefits if he has a total and permanent non-service-connected disability or is age 65 or older. Needy widows and minor children of deceased wartime veterans also are eligible for pension benefits.

Provisions of existing law which determine the amount of pension payments that eligible veterans or their survivors receive have resulted in inequitable treatment among pension recipients and are inconsistent with the principles of other Federal income security programs. The pension reform provisions of S. 2635 retain the basic eligibility tests of current law while restructuring the pension program itself.

The goal of S. 2635 is to correct inequities and technical problems in the current VA pension program. Such corrections are intended to result in a better targeting of funds on the neediest recipients. Major reform provisions include—

- (a) the creation of a system which more smoothly relates benefits to income;
- (b) an automatic adjustment in the basic level of annual income wherever social security benefits are increased;
- (c) elimination of 11 of the 18 existing income exclusions, including the total exclusion of spouses' earned income in pension payment calculations;
- (d) equalization of widows' benefit rates; and
- (e) revisions in the aid and attendance allowance and housebound allowance payment system.

Budgetary impact

The Congressional Budget Office and the Veterans Administration have provided the Senate Budget Committee with estimates of the fiscal 1977 costs of implementing the pension reforms of S. 2635. Based on the best available data, it is estimated that the pension reform package will have a net cost of from \$390 to \$460 million in fiscal 1977 over and above the cost of extending current pension law with anticipated cost-of-living increases. Included in the 1977 estimate are offsets that would result because of reduced SSI and food stamp benefits which many individuals eligible for pension benefits are now receiving.

The number of veterans' pension beneficiaries is expected to increase markedly in the next decade as large numbers of World War II veterans reach retirement age. Thus, a corresponding growth in total pension payments can be expected to occur during that period. This trend was taken into consideration when the Senate Committee on Veterans Affairs developed S. 2635. Because the final pension reform package has restructured the pension program by simultaneously increasing benefits to the neediest veterans and lowering eligibility for those benefits, Congress can expect a control of program growth as

World War II veterans enter the system. Although 5-year projections are difficult to make because of a lack of detailed information about the age and income characteristics of the future aged veteran population, the evidence suggests that S. 2635 would result in a long-term cost-savings by the mid-1980's.

Status of legislation and schedule for action

S. 2635 was passed by the Senate in December 1975. Because the pension reforms will affect fiscal 1977, a Budget Control Act section 303(a)(4) waiver was required prior to consideration of S. 2635 on the Senate floor. The Senate Budget Committee favorably reported the waiver resolution in view of the Senate Veterans Committee's efforts to encourage the House to accept pension reforms. The waiver resolution was agreed to by the Senate prior to passage of S. 2635. Although the House Committee on Veterans Affairs has not yet considered pension reform measures, it is expected to do so in the near future so that legislation can be agreed to by the House and the Senate by early summer.

On December 17th and 18th, the Senate and House respectively agreed to H.R. 10355, a bill to provide an 8-percent cost-of-living increase to veteran pensioners. Prior to Senate passage of H.R. 10355, an amendment was added to the bill which limits the 8 percent increase to a period beginning January 1, 1976 and ending September 30, 1976. By adding this amendment, the Senate hoped to spur House consideration of pension reform measures.

COAL MINERS DISABILITY

Legislation

BLACK LUNG BENEFITS REFORM ACT (H.R. 10760)

The Federal Coal Mine Health and Safety Act of 1969 was developed as a response to the black-lung related health and compensation needs of disabled miners in coal-producing States.

The act provided for the development and implementation of health and safety standards to minimize conditions in mines which cause black lung disease; creation of a Federally financed compensatory income and health benefits program for disabled miners and their survivors; and development of a program, effective in 1973, that would relieve the Federal Government of *future* liability for miners' compensatory benefits through a system of State-administered compensation plans financed through assessments on coal mine operators.

By the early 1970's, it was apparent that many disabled miners and their survivors were not technically eligible for benefits and that the proposed 1969 plan for transferring the total responsibility for black lung payments from the Federal Government to the States and coal mine operators was unworkable. In an attempt to resolve these and other specific problems, the House Committee on Education and Labor has reported a bill, H.R. 10760, to amend the Federal Coal Mine Health and Safety Act. Major amendments include a number of pro-

visions to expand the beneficiary population and provisions establishing a non-governmental trust fund financed by an assessment on all mine operators but initially funded by a repayable U.S. Treasury loan. The new trust fund would assume total responsibility for the payment of black lung benefits to those miners and their survivors who applied for benefits after December 31, 1973, as well as to those miners and their survivors eligible to apply for benefits under the new law. The Federal Government would continue to be liable for the payment of black-lung benefits to those miners and their survivors who applied for benefits on or prior to December 31, 1973.

Budgetary impact

The Congressional Budget Office estimate of costs for H.R. 10760 indicates that provisions of the bill expanding the beneficiary population would add \$122 million to the estimated \$1 billion to be paid miners in fiscal 1977 under existing entitlement law. Further, the reimbursable trust fund loan would result in an additional expenditure by the government during fiscal 1977 of \$67 million, for a total cost of \$189 million in fiscal 1977. It should be noted that the trust fund will be assuming the liability for a projected \$38 million in black-lung benefits which the Federal Government would continue to be responsible for without changes in the law. Therefore, the estimated expenditures of \$189 million should be reduced by \$38 million to get an accurate picture of the net cost (\$151 million) to the Federal Government of H.R. 10760.

By fiscal 1982, the loan payback with interest, the decreasing benefit payment total due to the mortality rate of miners and their dependents for which the Federal Government will retain liability, and the savings to government resulting from the trust fund arrangement should produce a total savings of \$1 million during that year.

The language in H.R. 10760 is unclear and there is some question as to whether the initial trust fund loan will be regarded as an off-budget item. Although the net cost estimates made by CBO will remain the same regardless of the outcome of this decision or subsequent language changes made in H.R. 10760, the specific budgetary impact is difficult to ascertain. If the trust fund is determined to be on-budget, outlays will be increased by \$67 million. If the trust fund is determined to be off-budget, outlays will not reflect the \$67 million loan to be made to the trust fund by the Treasury. It is likely that this issue will be resolved prior to final passage of H.R. 10760 by the House.

Status of legislation and schedule for action

The House Committee on Education and Labor reported H.R. 10760 on December 31, 1975. The bill is presently awaiting floor action. Consideration of the bill by the House prior to May 15, 1976, would require a Budget Control Act section 303(a) waiver resolution.

There is no comparable black-lung legislation pending before the Senate, but the Senate is likely to give such legislation rapid review once a bill is passed by the House.

SUPPLEMENTARY SECURITY INCOME

Legislation

SUPPLEMENTAL SECURITY INCOME PROGRAM REVISIONS (H.R. 8911 AND H.R. 8912)

Both H.R. 8911 and H.R. 8912 would liberalize the supplemental security income program by amending Title XVI of the Social Security Act.

In addition to a number of programmatic, eligibility, and benefit changes with negligible or small growth effects, these bills would—

- (a) extend presumptive SSI eligibility to blind individuals;
- (b) provide for a mandatory "pass-through" by States of Federal SSI increases, with Federal fiscal protection against the increased State costs of such a requirement provided to six States;
- (c) extend the SSI program to Puerto Rico, Guam, and the Virgin Islands;
- (d) change from 33 percent to 20 percent the reduction in benefits for an individual when he is living in the household of another person and receiving in-kind support;
- (e) provide for the exclusion of SSI cost-of-living increases in the determination of income in computing eligibility for benefits under various housing assistance programs; and
- (f) change existing law to allow an SSI recipient to receive additional financial assistance for housing costs if these costs exceed 33⅓ percent of the recipient's annual income.

It is the intent of this legislation to alleviate the financial burden on SSI recipients who, because of local market conditions, are forced to pay housing costs that are beyond their limited means.

Budgetary impact

The Administration's cost estimates indicate that the first full-year cost of H.R. 8911 would be \$450 million and the first full-year cost of H.R. 8912 would be \$825 million.

Status of legislation and schedule for action

The Subcommittee on Public Assistance of the House Committee on Ways and Means has favorably reported H.R. 8911 and H.R. 8912 to the full committee for action. At present there is no timetable for full committee action. The Administration opposes the more costly provisions of the proposed SSI revisions.

Because amendments to the Social Security Act must technically be initiated by the House, there are no Senate measures comparable to H.R. 8911 and H.R. 8912. If these bills were referred to the Senate by July 1, 1976, action possibly could occur before the end of the session.

RETIREMENT INCOME TAX CREDIT

Legislation

TAX REFORM ACT OF 1975 (H.R. 10612)

Under present law, individuals who are 65 years of age or over may receive an income tax credit based on the first \$1,524 of retirement

income. The credit is 15 percent of this retirement income. Each spouse who is 65 or over may compute his tax credit on up to \$1,524 of his own retirement income (whether the couple files separate or joint returns). Alternatively, spouses 65 or over who file joint returns may compute their credit on up to \$2,286 of retirement income (one and one-half times \$1,524), even though one spouse received the entire amount of the retirement income.

To be eligible for the credit an individual must have received more than \$600 of earned income in each of the prior 10 years. (A widow or widower whose spouse had received such earned income is considered to have met this earned income test.)

Retirement income, for purposes of this credit, includes taxable pensions and annuities, interest, rents, dividends, and interest on Government bonds issued especially for the self-employed setting aside amounts under retirement-type plans.

The maximum amount of retirement income which an individual may claim (\$1,524, or \$2,286 for certain married couples) must be reduced by two broad categories of receipts. First, it must be reduced on a dollar-for-dollar basis by the amount of social security, railroad retirement, or other exempt pension income received by the taxpayer. Second, the maximum amount of retirement income eligible for the credit is further reduced by one-half of the annual amount of earned income over \$1,200 and under \$1,700 and by the entire amount of earned income in excess of \$1,700. This reduction for earned income does not apply to individuals who have reached age 72.

Individuals under age 65 also are eligible for tax credits for retirement income but only with respect to pensions received under a public retirement system. Only income from a pension, annuity, retirement, or similar fund or system established by the United States, a State, or a local government, qualifies under this provision. This restriction of retirement income for purposes of the credit to income from a public retirement system applies only until the individual reaches the age of 65; thereafter he is entitled to take the credit on the same basis as other individuals who have reached that age.

H.R. 10612 proposes a redesign of the present retirement income credit for several basic reasons. One reason is that the credit needs updating. Most of the features of the present credit have not been revised since 1962 when the maximum level of income on which the credit is computed was set and when the current earnings limits were established. Since then, there have been numerous revisions of the social security law which substantially liberalized the social security benefits. As a result, the present maximum amount of income eligible for the credit is considerably below the average annual social security primary benefit of \$2,271 received by a retired worker and the average social security primary and supplementary benefit of slightly over \$3,400 that could be received by a retired worker and his spouse.

In addition, the complexity of the present retirement income credit prevents it from providing the full measure of relief it was intended to grant to elderly people.

The purpose of all these provisions is to provide individuals who receive little or no social security benefits the opportunity to receive tax treatment roughly comparable to that accorded those who get tax-exempt social security benefits. However, the result has been to impose severe compliance burdens on large numbers of elderly people,

many of whom are not skillful in filing tax returns. These complexities undoubtedly account for the estimate that as many as one-half of all elderly individuals eligible to use the retirement income credit do not claim this credit on their tax returns.

The present retirement income credit discriminates against individuals with modest income depending on the source of their income. As indicated above, the credit is available only to those with some form of investment or pension income in the taxable year. Elderly individuals who must support themselves by earning modest amounts and who have no investment or pension income are not eligible for any relief under the present credit. This has given rise to considerable criticism as to the fairness of the tax law; many elderly individuals who rely entirely on earned income maintain that they should be allowed the same retirement income credit as those who live on investment income. Under the present credit, elderly people who rely entirely on earned income are required to pay substantially higher taxes than individuals who are comparable in every respect except that they have significantly larger incomes which come from investments. Another criticism is that higher taxes on earnings than on retirement income serve as a disincentive to work.

To deal with the problems described above, the bill would update the amount on which the credit is based. It would deal with the problem of complexity by no longer attempting to pattern the credit closely after the social security provisions. Instead, to the extent practical, complicating features of the credit which previously were included in order to parallel social security treatment are eliminated. Thus the \$600 for 10-years' earnings test is eliminated, as is the requirement that the taxpayer have "retirement income" (that is pension or investment income) in order to be eligible for the credit. In addition, the variation in treatment of married couples depending on whether they are separately eligible for credits is eliminated.

The bill would improve the equity of the provision by making the credit more generally available to those age 65 or over. The major change in this area is the elimination of the cutback of the credit for earned income. It was concluded, however, that in view of the broadening of the credit generally and the change in its nature to focus relief on low- and middle-income taxpayers, it is not necessary to provide the credit to higher income taxpayers. Consequently, the maximum amounts of the base for the credit are reduced by one-half of the adjusted gross income in excess of \$7,500 for a single person and \$10,000 for a married couple filing a joint return (\$5,000 for a married taxpayer filing a separate return). Thus, for a single person, the credit would no longer be available when his adjusted gross income reaches \$12,500 (\$7,500 plus two times \$2,500). For a joint return the credit would be available up to an income level of \$15,000 if only one spouse is age 65 or over and up to \$17,500 if both spouses are age 65 or over.

The most significant extension of the credit is that for the first time it would benefit low-income earners age 65 or over regardless of whether they receive retirement income or earned income. Since the credit would no longer be limited to retirement income, it will be renamed the "credit for elderly."

Budgetary impact

These changes in the retirement income credit would reduce income tax revenues (increase tax expenditures) by \$340 million annually.

Status of legislation and schedule for action

The retirement income credit provisions were included in the tax reform bill passed by the House last year. The Senate Finance Committee plans to hold hearings on tax reform in March 1976, but no definite schedule for legislation has been set.

U.S. AND U.S.S.R. MILITARY SPENDING

(125)

Preface

This paper was prepared to provide background for the deliberations of the Senate Budget Committee prior to its markup of the First Concurrent Resolution on the Budget for Fiscal Year 1977.

The report was prepared by Thomas A. Dine and Robert D. Sneed of the Senate Budget Committee staff and Robin Pirie of the Congressional Budget Office staff.

EDMUND S. MUSKIE,
Chairman.

U.S. AND U.S.S.R. MILITARY SPENDING

I. Introduction and Summary

An important determinant—though not the only one—of American foreign and military policy, and therefore of the U.S. defense budget, is the Soviet Union's stance. This study is designed to examine and evaluate (1) the policy pressures which have pushed Soviet defense spending upward over the past 15 years, (2) the significance of comparing U.S. and U.S.S.R. military spending, and (3) the implications of Soviet strength for the United States in the FY 1977 through FY 1981 budgets and beyond. The study is intended to serve as a vehicle for discussion by the Senate Budget Committee of U.S. strategic and general purpose force needs during the FY 1977 debate over the defense budget.

U.S.S.R. PERCEPTION OF SECURITY SITUATION

Section II (pages 132-142) analyzes the Soviet Union's perception of its external and internal security situation. In the international arena, Moscow sees Peking as a "great danger," a threat about which Communist Party chief Leonid Brezhnev reminded the 25th Communist Party of the Soviet Union (CPSU) Congress on February 24, 1976. Since the split between the Soviet Union and China, the U.S.S.R. has pursued a rapid buildup of its forces. One fourth or more of Soviet armed forces are deployed in Asia to counter China and the Chinese nuclear arsenal which is aimed at Moscow and other crucial targets deep inside Western Russia.

The maintenance of the status quo in Eastern Europe is another primary objective of Soviet military policy; 31 Soviet Army divisions are deployed in Eastern Europe to maintain order according to Moscow's terms.

ARMS COMPETITION

With regard to the United States, the U.S.S.R.'s overriding objective has been to achieve strategic nuclear parity. In 1962, the United States enjoyed a five-to-one superiority in strategic missiles, a three-to-one superiority in strategic bombers, and naval superiority on and under the seas. After the Cuban missile crisis, the Soviets determined never again to be caught in similar circumstances and sought genuine great power status. A rough strategic equality now exists. Both sides maintain a strong second strike capability and will likely maintain such destructive capability through vigorous research and development programs.

An arms competition in general purpose forces is also in process. In Europe, the Warsaw Pact enjoys a quantitative advantage; NATO has a qualitative advantage. Worldwide, the Soviet military reach remains modest in comparison to that of the United States. Gen. George S. Brown, chairman of the Joint Chiefs of Staff, pointed this out in his military posture statement to Congress for FY 1977. "The U.S.S.R. currently possesses only a limited capability," he said, "to project substantial general purpose military power beyond the Eurasian continent."¹

Along with its strategic and conventional buildup, Moscow has embarked on an effort to influence events in Third World countries. Weapons for invention purposes are becoming a routine part of the Soviet inventory. The transfer of sophisticated conventional arms abroad, most notably before to Egypt and now to Syria, is a tool of Soviet diplomacy; the Soviets are currently sending materials to southern Africa to fuel "wars of liberation."

Internally, a close relationship exists between Brezhnev and the military. At the end of the 25th Congress, for instance, Dmitri F. Ustinov, head of defense industries and space matters, was made a member of the politburo. Then with Marshal Grechko's death, Ustinov became defense minister. At about the same time, Brezhnev was elevated to the rank of marshal. Although controversy and uncertainty surrounds these developments, there is a clear political pattern: Brezhnev has provided the defense ministry, in return for its political support, the funds for the military buildup.

The Soviet military posture vis-a-vis China, Eastern Europe, the United States, and the Third World, plus the momentum created by the party-military amalgam,² must all be weighed as the U.S. evaluates its own security needs in the face of the Soviet threat.

RELEVANCY OF COMPARATIVE MILITARY SPENDING

Section III of this study (pages 143-147) asks whether a comparison of U.S. and U.S.S.R. military spending is relevant in evaluating America's military needs. Must the United States spend at a rate comparable to Soviet military spending to ensure America's security?

A major administration justification for requesting a substantial increase in FY 1977 defense funds is the upward spending trend of the U.S.S.R. military budget. It is contended that, in response to the growth in Soviet military programs, the United States must modernize and expand its forces to maintain a "sufficient military capability."

Cost comparisons, however, are crude indicators. Information on actual Soviet outlays is incomplete. Moreover, dollar costing of Soviet military programs often estimates only what an item would cost if produced in the United States, without taking into account Russian propensities toward simpler and more rugged machinery or toward standardization. There are similar problems with ruble costing, which

¹ Statement by Gen. George S. Brown to the Congress, "United States Military Posture for FY 1977." January 20, 1976, p. 9.

² William E. Odom, "Who Controls Whom in Moscow." *Foreign Policy*, Summer, 1975.

are compounded by the fact that ruble prices for Russian weapon systems are not always available.³

Whatever the methodology applied, the test of military spending is how much added security is bought by the money. Focusing on outputs raises a more fundamental question: What kind of political will and military capability do the United States and NATO require in defending their interests and in implementing their common foreign/military policy? Stated another way: Should we match inputs with the Soviet Union, or should the United States tailor its military programs to provide specific outputs where the country perceives the need for them?

Secretary of State Henry Kissinger has stressed less the alleged weapons gap/spending gap and more the attempt "to build a pattern of relations in which the Soviet Union will always confront penalties for aggression and also acquire growing incentives for restraint." In his March 11, 1976, Boston speech, the Secretary noted the considerable unevenness with which Soviet power is evolving, that Soviet society is no longer totally cutoff from contact with the influences of the world around it, nor is it without its own needs for more normal external relationships. At the same time, it is recognized that the Soviet Union perceives it has security needs peculiar to its own geopolitical position.

"Despite the inevitable increase in its power," he said, "the Soviet Union remains far behind us and our allies in any overall assessment of military, economic, and technological strength; it would be reckless in the extreme for the Soviet Union to challenge the industrial democracies."⁴

QUANTITATIVE COMPARISON OF MAJOR MISSION FORCES

Section IV (pages 148-165) provides a quantitative comparison of major mission forces of the U.S. and U.S.S.R., including a presentation of relative NATO and Warsaw Pact force strengths. It highlights the substantial growth in strategic and general purpose forces the President is requesting in his FY 1977 defense budget, and the implications of this growth through FY 1981 (and beyond for selected weapon systems).

The force comparisons show increased Soviet force levels and technological advancements. They also suggest the U.S.S.R. has achieved rough numerical parity in certain mission roles with the United States. However, it is evident that the strategic qualitative balance remains in favor of the United States, a lead it will retain at least through FY 1981.

To retain "sufficiency" or "rough equivalency," a 7-percent increase in total obligational authority for FY 1977 is proposed. There is 14 percent real growth in strategic and general purpose forces because of the acquisition of many weapons to meet suspected threats.

³ Central Intelligence Agency, "A Dollar Comparison of Soviet and U.S. Defense Activities, 1965-1975." SR 76-10053, February 1976. *See also* Central Intelligence Agency, "Estimated Soviet Defense Spending in Rubles, 1970-1975." SR 76-10121U, May 1976.

⁴ Speech by Secretary of State Henry A. Kissinger, Boston, March 11, 1976.

The overall defense budget projections for FY 1978 through FY 1981 suggest at least 8 percent real growth during that period, approximately the same as FY 1976 to FY 1977. The outyear impact of the FY 1977 program will probably result in another 10 to 15 percent real growth for strategic and general purpose forces in the FY 1978 through FY 1981 time period. A 25- to 30-percent real growth in strategic and general purpose forces could thus be realized from FY 1976 to FY 1981.

QUESTIONS TO BE ADDRESSED

To a considerable extent, FY 1977 budget decisions will largely determine the U.S. military force posture for the year 2000. Before committing the United States to such heavy spending, these questions need to be addressed:

- To what extent is U.S. security to be defined in terms of the amount of military spending by our major adversary or by increased U.S.S.R. arms capability?
- Are substantial increases required in the defense budget in FY 1977 through FY 1981 when the United States holds a qualitative lead in its strategic force and America's assured destruction capabilities are continually upgraded?
- Because SALT-era decisions by the Soviet Union dealing with the deployment of new weapons are unknown, should the United States forge ahead with the deployment of a whole new generation of weapons?
- Is not "sufficiency" a standard based on what the United States can do despite opposition from the U.S.S.R., not on what each side has and is building?
- What defense posture can be achieved by 0 percent, 1 percent, 2 percent, 5 percent, or 10 percent real growth in strategic and general purpose forces in FY 1977?

To sustain U.S. security, it is not clearly evident that world requirements warrant growth of the size proposed in this and subsequent year budgets.

II. Soviet Foreign/Military Policy

Since the early 1960's, the Soviet Union has been modernizing and expanding its defense forces. The Brezhnev-headed team of new leadership which began its rule in 1964 made it national policy not only to continue increasing Russian military power, but to project that power to an extent far beyond that proposed by Stalin or Khrushchev. Beginning in 1968, U.S.S.R. defense spending began increasing at a rate of 2.7 percent per year. During this same period (with 1968 being the peak year of the American military effort in Vietnam), U.S. defense spending decreased. Only last year did the U.S. experience real growth in military spending, particularly for research and development and procurement purposes. Even more growth is proposed in FY 1977.

INTERPRETATIONS OF SOVIET DEFENSE/FOREIGN POLICY STRATEGY

Why has the Soviet Union chosen a course which steadily increases its spending for military forces and weaponry? What is the foreign policy rationale behind this effort? Has increased military spending

been influenced by reasons of ideology or by perceptions of national interest or a combination of both? To what degree have U.S. policy decisions and actual weapons developments influenced Russian defense decisions? What bureaucratic forces are at work in Moscow which affect decisions regarding Soviet force deployment?

Interpreting the decisionmaking process within the Russian ruling elite is neither a sophisticated nor a well-advanced science. Indeed, it appears closer to a primitive art. Secrecy and Soviet propaganda shield the policy process from close scrutiny; a dearth of hard information exists.

Soviet watchers in the governments of the NATO alliance, for instance, diligently study a variety of secret and open materials, but these materials are too frequently unrelated pieces of an incomplete puzzle and remain unlinked to the main issues. The analytical product, consequently, is admittedly imprecise. Interpretations of the rationale behind the Soviet Union's foreign/military thrust vary considerably, depending on one's view of the country's expansion-coexistence duality. Is the U.S.S.R. reacting primarily defensively in response to Chinese or NATO initiatives, or is the Soviet Union pursuing a long-term policy of eventual military dominance?

Official and unofficial American interpretations show a significant lack of consensus about U.S.S.R. policy. Former Defense Secretary Melvin Laird has expressed the belief that increased Soviet military spending provides incontrovertible evidence that "The Soviet Union has engaged in a relentless effort to attain military supremacy." This view perceives the U.S.S.R. to be driven by its ideological mission to dominate. Secretary Kissinger regards the rise in defense spending on both sides to be more a result of bureaucratic politics, with the military services of both superpowers having an upper hand in determining resource allocation. "My impression from what I have observed," Kissinger said at a July 3, 1974, press conference, is that both sets of civilian leadership "have to convince their military establishments of the benefits of restraint, and that is not a thought that comes naturally to military people on either side." Another important view attributes the steady rise of Soviet defense spending as a response to perceived security threats peculiar to the Soviet Union.

STATISTICS MEANINGLESS

Journalists and scholars who follow Soviet society closely have portrayed a picture of subtlety and ambiguity. For instance, two new books on contemporary Russian life by correspondents Robert Kaiser of the *Washington Post* and Hedrick Smith of the *New York Times* provide impressions.¹ Both writers say the Soviet planned economy is sluggish; that it maintains a highly inefficient form of full employment; that Soviet industrial technology has been vastly overrated. Kaiser and Smith emphasize the country's development of computers is far behind the West's, and that its space accomplishments were more crude shadows than sophisticated substance. Kaiser argues that the Soviet Union's impressive economic growth statistics are essentially meaningless and have misled Western analysts into thinking the country is more advanced than it actually is. Even Soviet

¹ Robert Kaiser, *Russia: The People and the Power*. New York, 1976; and Hedrick Smith, *The Russians*. New York, 1976.

military strength, he adds, is misleading, for while it is now very real, it has come into being not as an outgrowth of technological strength but through sacrifice of potential economic vitality. Most Western analysts and observers share the view that the Soviets have over-committed resources to its defense sector.²

Soviet leadership admits giving the military top priority. Deputy Premier Nikolai K. Baibakov, chairman of the state planning committee, recently spoke of the tenth 5-year plan's goals. The first priority, Baibakov said, was developing the economy, increasing production efficiency, and "strengthening the defense potential." Second was reinforcing the national economic base, raising technological standards, and improving the quality of output. Raising the people's living standards was listed third and last.

This section of the spending study examines tendencies and trends in Moscow's foreign/military policy and the reasons for recent military development and deployment by the Soviet Union. The focus is on the external and internal factors giving impetus to increased defense spending.

A. EXTERNAL SECURITY SITUATION

The Soviet security situation, over the course of the last 15 years, has shifted considerably. While concern about Western invasion by American-led NATO forces and possession of nuclear weapons by West Germany has abated, Soviet concerns now focus, ironically, on its socialist neighbor and former ally, *China*. At the 25th Congress of the CPSU, Brezhnev said, "Peking's frantic attempts to torpedo detente, to obstruct disarmament, to breed suspicion and hostility between states, its efforts to provoke a world war and reap whatever advantages may accrue, present a great danger."

PROBLEM NOT NEW

China is not a new security problem for the U.S.S.R. In the early 1960's, Prof. Adam Ulam of Harvard University had written, "The problem of either containing China within the Communist camp or somehow expelling her has absorbed the Soviet policymakers to the point where other issues have become secondary." If the Kremlin were to confess what it undoubtedly feels, according to Ulam, it would say "that the major threat to the security of the Soviet Union is China and not the United States."³ Behind this fear is the fact that Chinese missiles can now reach Moscow and other targets in European Russia.

An October 1973 *Pravda* article admitted the Chinese had rejected the "confirmation of the validity of the Treaty of 1950." As the compact became void beginning in 1958, the Soviet Union chose to fortify the long and frequently forbidding 4,000-mile Chinese border with Russian troops and armament added to the two divisions already

² *The Economist* of February 14, 1976 says of Brezhnev's Russia, "The renewed stress on heavy industry (including the defense industries) in the Five-Year Plan published last month is . . . depressing news for the Russian consumer." p. 62.

³ Adam Ulam, *Expansion and Coexistence: Soviet Foreign Policy, 1917-73*. Second edition, New York, 1974, p. 678.

stationed in Mongolia. Border clashes stimulated the buildup. In March 1969, a major engagement was fought between Chinese and Russian forces on Damansky Island. (A Chinese-based account was detailed in the London *Observer* of September 23, 1973, and it claimed a Soviet defeat.) A series of border incidents occurred through the summer of 1969.

As a result, an extensive effort was made in moving Soviet troops eastward, adding to the two divisions already stationed in Mongolia. A new Central Asian military district was established, with responsibility for the Sinkiang border, and a missile specialist, Gen. V. F. Tolubko, was appointed to command the Far East military district. In September, Victor Louis, the renowned Soviet journalist, wrote about the danger of war, "The Soviet Union is adhering to the doctrine that socialist countries have the right to interfere in each other's affairs for their own interests or those of others who are threatened." He said, "The fact that China is many times larger than Czechoslovakia and might offer active resistance is, according to Marxist theoreticians, no reason for not applying this doctrine." The Chinese replied with two nuclear tests in Sinkiang. At the end of 1972, another alleged clash took place on the Sino-Soviet border between Kazakhstan and Sinkiang. It is reported that five Soviet guards were killed. In the 1970's, both countries have continuously waged psychological warfare as well.

U.S.S.R. ARMY BUILDUP

Since the late 1960's, the Russian Army has added 31 divisions to its military forces, 28 of which have gone to the Chinese border. A total of 43 divisions and two brigades are now deployed in Soviet Asia. It is important to note that this anti-Chinese buildup was accomplished without drawing down from any European-oriented forces. This involved additional extraordinary expenses. As section IV explains, they have also expanded air and missile forces east of the Urals. To support the anti-Chinese effort, extensive supply, maintenance, and reinforcement procedures have been developed in order to withstand Central Asian and Siberian weather and terrain conditions. In turn, China has built up a nuclear *force de frappe* of 20 to 30 IRBMs and about 50 MRBMs deployed in northeastern China with range capabilities sufficient to reach Moscow and most Asian areas.⁴

The Sino-Soviet split has altered the traditional deployment patterns of the Soviet Army. No longer is the concentration Europe-oriented; it now comprises an emphasis on both Europe and Asia. The purpose of the 43 divisions and two brigades along or near China is disputed: Either they are positioned as a preliminary preparation for a Manchurian invasion or as a strike force designed to eliminate China's nuclear arrangements or possibly as Jeffrey Record, formerly of the Brookings Institution, has written, merely as "a garrison force . . . although the offensive combat power of Far Eastern deployment could be rapidly augmented should circumstances require."⁵ Judging from the U.S.S.R.'s hectic weapons program, there

⁴ The International Institute for Strategic Studies. *The Military Balance 1975-1976*. London, 1975, p. 49. It is reported in the June 14 *Aviation Week & Space Technology* that the "Soviet Union has moved part of a third tank division into the area around Bulgan, Mongolian People's Republic, about 500 miles from the Chinese border."

⁵ Jeffrey Record. *Sizing Up the Soviet Army*. Washington, 1975, p. 19.

is no question that Brezhnev's policy is to speak softly while carrying big nuclear and conventional sticks which the Peking leadership must take into account.

EASTERN EUROPE

Another serious security situation which is of primary concern to Moscow is *Eastern Europe*. Czechoslovakia is the watchword. After the August 1968 uprising in Prague, five Soviet Army divisions were sent to Czechoslovakia, which is where they currently remain. Other political disruptions have caused the Soviets to reinforce troops and armaments in East Germany, Czechoslovakia, Poland, and Hungary, as well as in Western Russia. These concerns were (a) the 1970 workers uprising in Poland, (b) the independent foreign policies pursued by Romania, Yugoslavia, and Albania, resulting in a virulent 1971 press campaign accusing these three governments of forming an "anti-Soviet axis," and (c) the deep Soviet fear of the domino theory in its own sphere of influence. A total of 31 motorized and armored U.S.S.R. divisions reside in Eastern Europe.

Moscow saw the course of "liberalizing" events in Czechoslovakia in 1967 and 1968 as a threat to the stability of other Communist regimes in Eastern Europe and, according to some observers, not inconceivably led to disturbing reverberations within the U.S.S.R. itself. When the invasion occurred, the Soviets had explored the situation well enough in advance to know the Red Army would not be met with armed resistance. Four hundred thousand Warsaw Pact soldiers, overwhelmingly Soviet, seized a country of 14 million people.

In Poland, the Soviet Army was on the brink of intervention around Christmas 1970 when workers concentrated in the maritime provinces responded to food price rises by storming Communist Party headquarters. It is reported casualties were sizeable. The crisis was allayed when Gomulka was removed, his subordinates demoted, and Edward Gierek, the new premier, rescinded the price increases and personally visited the troubled area. In Eastern Europe, the Soviet Union, by its "anxious authoritarianism," has made it clear that it is determined to preserve socialist society against local nationalisms and anything new in Marxist thought and is determined not to permit further loosening of the bonds that hold the socialist camp together.⁶ This includes the proximity of force in case the spirit of cooperation with Western Europe and the United States becomes more tangible in this volatile area.

SOVIET SECURITY RELATIONS WITH U.S.

With regard to security relations with the *United States*, the Soviet Union foreign/military policy goals are complex and ambivalent. Since the October 1962 Cuban missile crisis, the Soviets have traveled two roads, increasing the number of their own strategic nuclear weapons while seeking agreements on general limitations and on non-proliferation of nuclear powers.

Kremlin policymakers have aspired to nuclear parity with the United States. Achieving this parity has been the greatest accomplishment of Brezhnev's period of rule. Today the Soviet Union is universally acknowledged to be a superpower. (But the word superpower

⁶ Thomas W. Wolfe, *Soviet Power and Europe, 1945-1970*. Baltimore, 1970 p. 404.

is not part of the Soviet vocabulary. When it is used, it appears in inverted commas. In the official *History of Soviet Foreign Policy*, the Soviet Union is described as "one of the greatest world powers, without whose participation not a single international problem can be solved." Brezhnev, for instance, in Washington in his June 1973 meeting with Senators, brushed the term superpower aside. A partial reason for such modesty is the pejorative significance the term has acquired in China's political vocabulary; the Chinese disclaim any intention of aspiring to superpower status themselves.)

RETALIATION POSES UNACCEPTABLE RISK

The U.S. and U.S.S.R. have established a situation of mutual deterrence. For the Soviet Union, as for the United States, the prospect of nuclear exchange against a power capable of massive retaliation by vast numbers of weapons from under the sea, from land, and from the air, poses unacceptable risks. So now the Soviets seem to be playing the strategy of deterrence. Moscow has the arsenal to threaten its opponent with such severe retaliation for an attack that they assume the rationally calculating United States will choose not to initiate an attack. Such a large negative payoff is now a reality. But, the fact the U.S.S.R. rejects the actual use of nuclear weapons does not preclude their using them as a bargaining card at the conference table. The Soviets raise the question: Would Washington, while facing a crisis like that of the Cuban missile showdown, behave the way it did then if it knew Soviet nuclear power was now roughly equal to its own? The United States raises the converse question. In the 1972 arms control agreements between the U.S. and U.S.S.R., the United States sought to stabilize the present level of the two powers' nuclear arsenals. SALT I enabled each side to proclaim that it had achieved its aim: Russia had reached at least parity with the United States; America had preserved its lead. The same face-saving formula holds for the Vladivostok guidelines and the thrust of the SALT II agreements and disagreements.

Another angle to the Kremlin *Westpolitik* policy with the United States and West Germany is not to appear too much the supplicant. In this regard, Brezhnev's attitude toward projecting a stance of strength is similar to that of Khrushchev, who in December 1961 acknowledged in a public speech, "If you and I come up to the imperialists carrying a cross and praying, and on our knees begin to implore them to be humane, they would laugh at us, they would see in this our weakness and their strength."

Professor Ulam has interpreted this Russian thought process in the following way: Brezhnev and the others "have been only too conscious that any friendly overture (detente) on their part would be interpreted in the West as due to Moscow's fear of China and/or serious domestic troubles within the U.S.S.R. And so, while seeking a detente, the Soviet Union would not appear to be pleading for it, would never appear to be negotiating out of fear, rather than in pursuance of the immutable goals of Soviet foreign policy."⁷ Despite the appearance of power, the rapid Soviet nuclear stockpile buildup and development of sophisticated delivery systems in the 1960's and 1970's can be understood only partially as the result of the Soviet's desire to reduce

⁷ Ulam, *op. cit.*, p. 749.

America's superior position, but more urgently as an expression of their need to establish a crushing superiority over China's evolving nuclear power.

Brezhnev and his successors clearly will not settle for less than nuclear parity. It has become the Soviet national interest to preserve a strategic balance with the United States. The paradox of this balance is that it now places on the shoulders of the Soviet Union, as it already has on the United States, a serious consequence. Even under technologically stable conditions of mutual deterrence, there is no limit to strategic arms research and development, and deployments not limited by SALT. In fact, if both countries were to undertake a continuous search for qualitative improvements in their nuclear forces and otherwise hedge against the threat of the other, a series of interactive deployments could occur, driving both sides to higher levels of potential destructiveness until constraining symmetrical agreements are reached.

GENERAL PURPOSE FORCES

General purpose forces are another element of the Soviet military growth. The increase is related not only to offsetting China and NATO and snuffing out liberal movements in Eastern Europe, but also to a strategy aimed at the *Third World*. There are two main military prerequisites which determine the credibility and the effects of foreign policy commitments. The first is the nation's ability to provide sufficient military support to fulfill pledges made. The second is the awareness of others of its willingness to provide such support. Until the mid-1960's, the Soviet Union lacked the capacity to intervene effectively in areas outside its adjacent environment as the Guinea, Ghana, and Congo episodes demonstrated. But once the United States intensified its intervention in Vietnam and became mired down in that expanded affair, unable to win the war and unable to cut its losses and extricate itself fully until the spring of 1975, opportunities arose for advancing Soviet influence in many parts of the world. Ironically, this was helped along by the passing in 1967 of the danger of a Soviet-American confrontation over Vietnam. Since then, however, the Vietnam impasse reduced Washington's ability and the American people's willingness to counter Soviet moves in places like Egypt, Syria, Nigeria, Somalia, Angola, and Communist Party efforts in Portugal and Italy.

In order to intervene in areas not adjacent to its borders, the Soviet Union has begun to develop weapons suitable for the circumstances. For instance, in the late 1960's, part of the motivation behind the expansion of the Soviet naval building program was force projection. Surface ships like helicopter carriers—although these primarily have an anti-submarine warfare (ASW) mission—and amphibious marine landing capabilities were emphasized. Moscow's rationale is obvious: In a crisis the salvation of some pro-Soviet regime may depend on a speedy landing and intervention. In 1967, an all-jet Soviet vertical takeoff and land (VTOL) fighter was unveiled; an advanced version is now assigned to the helicopter carriers. As the Yom Kippur War and the Angolan situation showed, the Soviets have a new airlift ability. The extensive utilization of helicopter strength and the giant AN-22 transports allow for much greater mobility.

In addition to international concerns affecting Soviet perceptions of needs, there are forces at work internally influencing Soviet military spending.

B. INTERNAL SECURITY CONSIDERATIONS

Institutional forces have affected Soviet decisions regarding the size of the Soviet armed forces. During the Stalinist period, arms policy was constrained by traditional military thinking, emphasizing defensive forces. The intensive increase began at the end of the dictator's reign. In the mid-1950's, the technological missile and rocketry base was established. The Soviet Navy started slowly, eventually expanding from an offshore fleet of land-oriented power into an oceanic fleet befitting a major maritime power. The Sputnik success highlighted a period of initial long-range missile development covering the years 1958 through 1961. Assured second-strike forces were developed from 1962 through 1966 and, to the present time, both counterforce capabilities and a global Navy emerged to challenge the United States and to permit and bolster intervention in countries far from the Soviet Union. During these periods of military development, institutional forces were at work inside the Soviet Union, affecting decisions to spend more on the military and its related programs.

INFLUENCES ON SIZE OF DEFENSE BUDGETS

The nuclear "action-reaction" phenomena in both the U.S. and U.S.S.R. has been documented.⁸ It is clear the United States will militarily match its major adversary. It appears the Soviet decision to match America's capabilities and operational flexibility occurred in 1966, as witness the great missile procurement increments and increased military budgets. By the end of the decade, Soviet ministry of defense authorities were insisting strategic superiority had been achieved, and that it must be retained.

The "action-reaction" process also motivated the Soviet's general purpose forces development. It provided military officials a reasonable basis within the bureaucracy to advance particular programs. Several Soviet military leaders in 1965, for instance, stressed the need for greater flexibility and improved quality of military doctrine. They focused not only on having forces directed against forces of the adversary, but on matching the combat readiness and deployment spread of NATO, too. NATO's asserted peacetime deployment of forces in the right places, NATO numbers, and proportions for the achievement "of its main war tasks in the short period" were held up for emulation. Similarly, the sinking of the Israeli ship *Eilat* in the June 1967 war by a missile from an Egyptian-manned Komar-class patrol boat

⁸ G. W. Rathjens, "The Dynamics of the Arms Race," *Scientific American*, April 1959; Herb York, *Race to Oblivion*. New York, 1970. Wolfgang K. H. Panofsky, "The Mutual Hostage Relationship Between America and Russia," *Foreign Affairs*, October 1973; Jerome H. Kahan, *Security in the Nuclear Age*. Washington, 1975; and John Steinbruner, "Beyond Rational Deterrence," *World Politics*, January 1976. The phenomena has been debunked by T. W. Wolfe and Fritz Ermath in their paper entitled "Interaction Process and Its Influence on Major Soviet Arms Decisions." (U) Rand Corporation, R1180-PR, August 1971 (S) and by J. H. Depres in his memorandum "Russo-American Strategic Interaction: Military Budgets." (U) Rand Corporation, RM7447-PR, 1971 (S). See also two articles by Albert Wohlstetter, "Is There a Strategic Arms Race?" in *Foreign Policy*, Summer 1974 and Fall 1974.

spurred NATO efforts to develop comparable weaponry for member navies. The Norwegian Penguin, the French Exocet, and the American Harpoon were the result.

Another influence on the size of the Soviet defense budget and the expansion of military programs is the prominence given to the armed forces by Brezhnev. In 1964, the new leadership lost little time in assuring the military that the party held them in high esteem. Since then, the regime has stressed the autonomy and specialized nature of the military. The amorphous "Stalingrad group" has retained its hold on policy-influencing positions, but younger men have been promoted at an unusually high, although erratic, rate. These promotions have been based on the individual's experience with conventional and non-conventional weaponry; the trend is toward great specialization, providing for integration of nuclear and conventional specializations. Not only have younger men been promoted to commands (a large percentage of prominent incumbents in 1972, for instance, were under 60 years old, slightly less in the 50 to 55 age bracket, and some were even in their 40's), they also gained access to the highest policy councils. As professionalism increased, a basic comparability of party and military aspirations increased, and most problems pertaining to military issues and policy are left to Frunze Street. As the 25th Soviet Communist Party Congress makes clear, however, political and economic authority continues to be jealously held by the civilian leadership.

U.S.S.R. DEFENSE MINISTRY

Another element here is the close, personal links Brezhnev has had with military men throughout his political career. During the Second World War, as political commissar of the Soviet 18th Army, he began his long friendship with Gen. Andrei Grechko; on April 12, 1967, 12 days after Malinovsky died, Marshal Grechko became Brezhnev's defense minister. Other wartime and political colleagues now in key positions are Adm. Sergei Gorshkov, commander in chief of the Soviet Navy; Gen. Viktor Kulikov, chief of the Soviet armed forces general staff and a first deputy defense minister; Marshal Kirill S. Moskalenko, another deputy defense minister and presently the chief of the main inspectorate of the Soviet armed forces; Gen. Sergei Shtemenko, whom Khrushchev had demoted, was returned to rank and authority by Brezhnev and made chief of staff for Warsaw Pact forces (Shtemenko died this spring but has not yet been replaced); until his death in 1970, Marshal Andrey Yermenko served as inspector general of the Soviet defense ministry; Gen. Ivan G. Pavlovsky, also a deputy minister of defense and commander-in-chief of Soviet land forces (Pavlovsky commanded the units that invaded Czechoslovakia in 1968); Gen. Nikolai Lyaskchenko is Central Asian military district commander; Col. Gen. Anton I. Gastilovich is deputy head of the Soviet general staff academy; Col. Gen. Konstantin Gruskevoi is political commissar of Moscow military district; Lt. Gen. Nikita S. Demin is deputy chairman of civilian "volunteer assistants of the army, air force, and navy" (DOSAAF), a paramilitary and pre-military training organization; and Gen. Aleksei A. Yepishev is chief political commissar of the Soviet Army and Navy and a chief link for Brezhnev to the high command. In 1971, 20 high ranking military officers achieved full membership of the central

committee and, of these, seven are close political allies of the secretary general.⁹

DECISIONMAKING

Prof. Marshall D. Shulman of Columbia University has written a detailed description of the Soviet decisionmaking process on SALT matters which shows the military's present predominance in strategic issues, a process John Newhouse also documented in his book *Cold Dawn* about the SALT I negotiations. Shulman's description also notes the difference between decisionmaking in Washington and Moscow. He writes:

There is no Soviet analogue to the U.S. Arms Control and Disarmament Agency; no precise analogue to the National Security Council and its staff; and no circulation of defense scientists in and out of government, as in the United States, to provide an independent lobby and public debates on arms control issues. The Supreme Soviet, the legislative arm of government, does have standing commissions on foreign policy, which approved the first SALT Treaty, but in the Soviet system there is no equivalent to congressional committee hearings, which are independent of and often critical of the administration position during the period when decisions are being made. In the Soviet Union, the military play a larger role in originating positions on SALT than in the United States. The main locus of work on the preparation of positions for SALT is to be found in the Soviet ministry of defense, which has a section charged with this responsibility, under the general staff. Although the Soviet ministry of foreign affairs is involved in the process, its role is largely limited to the diplomatic and political aspects of the negotiations, and it is kept out of the technical hardware details of arms limitation problems. Between the ministry of defense and the party leadership are a number of important mechanisms for coordinating military policy with political and economic considerations, including the military council, on which Brezhnev sits as chairman, and the military industrial commission, which oversees the Soviet armament industry. The Soviet penchant for extreme secrecy on military matters has restricted technical information on arms control issues to a small circle within the Soviet military establishment, although the effects of summit meetings on SALT may have widened the circle of party and government officials who are informed and involved in arms limitation matters.¹⁰

⁹ John Dornberg, *Brezhnev: The Masks of Power*. New York, 1974. For a view of the central role of the party chief and the party in military policy formulation, especially Brezhnev as a "Bonaparte" in the Soviet system, see William E. Odom, "Who Controls Whom in Moscow," *Foreign Policy*, Summer 1975.

¹⁰ Marshall D. Shulman, "SALT: Through the Looking Glass." *Arms Control Today*, February 1975.

An analysis of Soviet military considerations affecting national policymaking written by Dr. Carl G. Jacobsen formerly of Harvard University contends, "Although the armed forces constitute only one of the policy-affecting instruments of the political leadership, the armed forces establishment is integrated into this political leadership to an extent which entails considerable influence on the choice of instruments." This influence extends to the economy. For example, at the 24th CPSU Congress in 1971, Brezhnev acknowledged that ". . . 42 percent of (the defense industry's) output is used for civilian purposes." The significance of this figure is also reflected in the privileged position of the defense's recruitment of scientists, the productive capacity of these industries, and the state of military/civilian integration. In that same speech, Brezhnev justified increased military spending because of the increasing American commitment to the Indochina war and to China's anti-Moscow bellicosity.¹¹

One result after a decade of Soviet military self-oversight is the lavish display of procurement. And the institutional momentum continues today. This level of military activity, of course, injects a large degree of uncertainty into any analysis of the relationship between increased military spending and Soviet ideology and national interest.

Another situation putting pressure on the Soviet military budget is the enlargement of para-military forces maintained primarily for internal security purposes. The KGB border guards and MVD security troops have grown substantially in recent years. The dissident voices of intellectuals and religious groups coupled with activities against Brezhnev by party members Shelepin (over ambition), Suslov (over Czechoslovakia), and Shelest (over *Westpolitik*), caused the leadership to exert more stringent and security-conscious controls on its own citizens. To this end, the home guard was instituted, armed and trained. With the onset of detente externally, increased repressive measures were taken internally.

VISIBLY INCREASED PREPONDERANCE

Viewed as a whole, the U.S.S.R.'s armed forces have expanded in recent years to provide a "visibly increased preponderance," to use Foreign Minister Gromyko's phrase, behind the country's foreign/military policy. The reasons for this military expansion are mainly based on the peculiar international and internal security situation the Soviet Union currently perceives it faces plus the psychological sense the leadership has of the country's role in world affairs. As a result, there is now a symmetry in the U.S./U.S.S.R. military balance and a shift of the Soviet Union from a continental power to a country with the modest capacity to intervene locally in contested trouble spots or create some of its own on faraway continents. Whether this military buildup will persist is unclear.

The forces in the field today are the result of decisions made before the Brezhnev policy of detente was enacted in 1972. The SALT-era decisions dealing with the deployment of new weapons are an unknown.

¹¹ C. G. Jackson, *Soviet Strategy-Soviet Foreign Policy: Military Considerations Affecting Soviet Policy-Making*. Glasgow, 1974.

III. Usefulness of U.S./U.S.S.R. Military Spending Comparisons

In analyzing the force balance between the U.S. and the U.S.S.R., are comparisons of military spending useful?

It is argued that such comparisons (a) can show the relative size of the effort devoted by each side to producing and maintaining military power; (b) provide clues to the intentions of each side; and (c) indicate a trend in relative military capability.

Spending comparisons serve to aggregate a very large number of different elements supporting military power into simple and apparently comprehensive sets of numbers. But if the forces and activities on both sides are given common weighting factors—prices, in effect—and the products aggregated, the resulting sums can be compared. Relative size and trends are immediately apparent. And since the weighting factors are money valuations, and most people believe they know the value of money, the resultant numbers have an appealing “feel” of reality.

Other uses of spending comparisons are thought to include helping to make judgments about the relative burden of military expenditures on the economies of rival states, about the efficiency with which rivals convert resources into military force, or about the real nature of crucial military balances.¹ Whether presently available spending comparisons are appropriate to these uses is a technical question to be taken up later in this section. But there can be little doubt that we would like to have a clearer understanding of these questions of burden, efficiency, and balance, and that the costs of the forces in question are relevant to these issues.

A. CRITICISM OF BUDGET COMPARISONS

The usefulness of cost comparisons as measurements of resource inputs to military forces has been challenged by Lt. Gen. Daniel Graham, retired former Director of the Defense Intelligence Agency. Graham expressed skepticism about the usefulness and validity, particularly of dollar costing, a technique that will be explained later in this section of the study. His reasons for such skepticism are based on his years of close association with intelligence on Soviet military programs. He was unable to believe that the very large increases in Soviet military forces, programs, and activities which he observed during that period were adequately reflected in the very slowly rising CIA cost figures covering the period. Graham testified before the Joint Economic Committee Subcommittee on Priorities and Economy in Government that, “As to dollar presentations, I will probably retain my basic distrust of results. They are simply misleading.” While it is not completely clear from Graham’s testimony whether he believes there might be a right way to do dollar costing and, if so, whether he thinks the result would be useful, there is a hint that he considers the problem to be fundamentally methodological. He stated,

¹ For example, the famous “PEMA-People Paradox” by Alain Enthoven and Wayne Smith, *How Much Is Enough? Shaping the Defense Program 1961-1969*, New York, 1971. The gist of the paradox is as follows: “The Warsaw Pact had overwhelming ground force strength in Europe, even though they have only slightly more men under arms than NATO, and spend about the same amount on their equipment, operations, and maintenance.”

for example ". . . I doubt that the Soviets, with full access to the data denied to us, could produce a valid dollar value of their defense efforts." This seems to imply a view that the problem is exceedingly difficult, but not, in principle, impossible.

COST COMPARISONS CAN BE USEFUL

Other observers appear to believe that cost comparisons could be useful if properly done. Andrew W. Marshall, Director of Net Assessment, Office of the Secretary of Defense, in a letter submitted to the Subcommittee on Priorities and Economy in Government for its hearings, wrote, "Properly conceived and executed analyses of comparative U.S. and Soviet defense expenditures can provide valuable insights into the status and trends of the two defense efforts." An enclosure to the letter is an extremely thorough and competent treatment of the technical problems involved in making cost comparisons, which concludes, among other things, "On balance, the current estimates tend to underestimate the size of the Soviet activity relative to U.S. defense expenditures. Little confidence is held, therefore, in the absolute magnitude of the Soviet dollar figure specified by the CIA documents."

In contrast to those who would concede some usefulness to cost comparisons, if properly done, are those who argue that such comparisons are irrelevant. This line of argument goes as follows: "It doesn't matter what the other side pays for its military forces. It is irrelevant. The real problem is how best to provide a countervailing military capability and that is an internal resource allocation problem unaffected by considerations of the costs the other side incurs."

Thus, we confront two differing interpretations regarding cost comparisons: Those who think they could be useful, if properly done, and those who think even theoretically impeccable estimates would not be relevant to the questions they purport to address.

B. COSTING METHODOLOGIES

Before discussing cost comparison methodologies and attempting to clarify the question of relevance, it is most important to stress that they are extremely complex technical exercises, and that argument about the details of costing or possible systematic bias in the comparisons are likely to be distracting and hence counterproductive. This is because a lot of the methodological problems are insoluble and others, given the massive number of individual calculations, each requiring assumptions, estimates, and approximations, are extremely uncertain as to their effect. Arguments over these points can go on at great length without reaching a conclusion.

DOLLAR COSTING

The technique by which *dollar costing* of Soviet military programs is pursued involves two steps: (1) cataloging all of the items involved in those programs; and (2) imputing a dollar cost to each. The cataloging involves counts of observables, such as army divisions, ships, aircraft, tanks, and so on. Many different intelligence-gathering techniques are required to make such counts, and where intelligence gaps exist, estimates of such items, the correct numbers, tempo of operations, logistics support, manning, and so forth must be made.

A large number of individual elements counted or assumed, and the uncertainty which accompanies the aggregation of catalog estimates can be quite large.

Imputation of dollar costs is a similarly complex and difficult task. On the surface it sounds simple: One simply estimates the cost of reproducing the item in the United States. This, however, soon proves more difficult than one might think. Where there are direct military analogues, for example, tanks of similar size, armor, and firepower, the cost of the Soviet system is taken directly as the cost of the similar U.S. system. Where there are no closely similar U.S. systems to Soviet systems, estimates must be made by U.S. cost estimators based on the observed or assumed characteristics of the Soviet system. The cost estimating relationships used in such estimates are usually those appropriate to U.S. industrial practice in the U.S. economy. They do not usually take account, for example, of Soviet propensities toward simpler and more rugged machinery, or toward standardization.² On occasion, where some well-known Soviet practice has a clearly identifiable impact on costs, the estimates are adjusted to accommodate this.

Marshall, in his paper referred to above, pointed out a specific problem with the costing of Soviet military manpower. The CIA's method of costing manpower is to derive an average U.S. cost-per-man by dividing the total manpower costs, including pay, allowances, and subsistence of a particular service by the total manpower in the service. This factor is, in turn, multiplied by the total manpower in the appropriate Soviet service to derive a total dollar cost. One of the problems with this, as Marshall pointed out, is that it assumes the grade and pay structure of the Soviet service is the same as that of its equivalent U.S. service—an unlikely assumption.

RUBLE COSTING

Ruble costing of Soviet defense programs involves much of the same kind of estimating process as the dollar costing. Ruble prices are available for many of the items in Soviet military programs, such as pay to individuals and items that are much the same as other items in the civilian economy, such as trucks. Ruble prices for Soviet weapons systems are not, however, available in the open literature. For such systems, what is commonly done is to make a dollar cost estimate, and then convert this to rubles by using a ruble-to-dollar conversion ratio based on a similar exchange ratio; e.g. for a tank, one might use what is known for tractors.

As the preceding brief discussion makes clear, there is a very large element of estimation in any of the cost comparison methodologies, and hence a large amount of uncertainty. Further, since the method used to make cost estimates frequently depends on available information, the basis of the estimates may change over time as more information becomes available or as sources of information are closed to us.

There is a final theoretical point to be made about cost comparisons of activities in different economies. The method of constructing the

² For example, it is reported that the diesel engine used in the Soviet T-54 tank is essentially the engine that has been in serial production in the U.S.S.R. since the mid-1930's.

aggregated defense costs resembles the method of construction of index numbers used for economic comparisons across time. It suffers from the same theoretical deficiency that index numbers do. That is, the evaluation of a collection of goods in one period by the prices prevailing in another does not exactly reflect its real value in either period, because there is no opportunity to change the mix of goods in response to changing relative prices between the periods. Given that relative prices do change between periods, the index number always overstates the value of one period's goods in another period's prices. Applied to spending comparisons, this means that dollar costing of Soviet programs, or ruble costing of U.S. programs tends to overstate the costs of both. A brief example may help clarify this. For the United States to attempt to duplicate a Soviet missile capability by making a "Chinese-copy" of a Soviet missile would be a very expensive undertaking, because U.S. industry and engineering just do not do things the way the Soviets do, and a lot of changing around and nonstandard practice would accompany such an undertaking. It would be cheaper to replicate the capability of the Soviet missile using the design and fabrication practices common in this country. But the point of this example is that Soviet practice is cheaper in the U.S.S.R. and U.S. practice cheaper in the United States because in both cases people have proceeded in ways to minimize their own costs, and these are different ways.

In summary, with respect to methodologies, there are theoretical reasons to think that cost comparisons between different economies are biased and there are practical reasons for thinking that there is considerable uncertainty in the CIA aggregated dollar cost and ruble cost estimates.

C. ARE THE ESTIMATES USEFUL?

Even if accurate, unbiased, and credible cost comparisons could be made between U.S. and Soviet military programs, would they be useful? To put the point another way, would it matter if one side were out spending the other on military forces? Clearly, the answer depends on what each side is obtaining from its resource inputs. What is important about military forces is certainly much more than their ability to absorb resources. Senator Proxmire has recently suggested that an explanation of estimated increased Soviet military spending is that the Soviets are learning to waste money on military programs at a much greater rate. What is meant by waste in this context should, perhaps, be the subject of another paper. But the important point is to be concerned with the relevant outputs.

One form of military output loosely linked to the input comparisons and size comparisons is the impact on the perceptions of adversaries and allies of one's military programs. It is how tough we appear; how much we reassure our friends; how much we deter our adversaries from testing us. This kind of military output has both political utility and drawbacks, and is certainly related to how much effort (money) we put into military programs, and how big our apparent forces are. It is perhaps less important in this regard that our apparent forces have a high degree of readiness, or have really competent, survivable weapons systems in real battle environments.

Another form of military output is generally termed "capability." It is the capacity to destroy enemy forces, defend friendly territory and forces, and generally to win military engagements. Calculating

such capability is a complex technical task which requires a host of assumptions about the engagement scenarios, characteristics of opposing systems, and many other things. However, it is this form of military output that many people think of in relation to money spent on military programs. But here the link between resource inputs and appropriate outputs is even more tenuous.

CONCERNS WITH REAL MILITARY CAPABILITIES AND REQUIREMENTS OR PERCEPTIONS OF POLITICAL USES OF MILITARY FORCES

Whether or not spending comparisons are relevant to discussions about how much to spend probably depends in the short run upon whether one is more concerned with perceptions and the political use of military forces, or with issues of real military capability. In the longer run these issues converge and thus credible spending comparisons can be useful in assessing trends in real military capability as well as in resolve and determination not to be second best. If one side puts more resources than the other into military programs consistently over a period of years, it is difficult to escape the conclusion that the first side will eventually accumulate a preponderant military capability. Such a military capability may still not give the first side a free hand in imposing its will on the other. The usefulness of military preponderance can have severe limitations. The significance of military superiority or inferiority is presumably an issue which is capable of being analyzed and settled on its own merits. To put the point another way, spending comparisons are not likely to be useful in predicting what happens as the result of one side or another achieving a lead in military capability.

There is considerable uncertainty about whether the costing methodologies presently in use to compare military spending in the U.S. and U.S.S.R. will support conclusions, at least in the short run, about the status and trends in real military capabilities between the two countries. There is difference of opinion about whether spending levels would be relevant measures even if the costing methodologies were credible. This leads to the conclusion that cost comparisons must be used with great care and discrimination in arguing appropriate policy options. At the least, such comparisons should be given context by reference to appropriate military outputs, and by reference to observable forces and activities of the U.S.S.R. As Marshall observes, ". . . the policy issue to which sizing analyses are directed would be better served if several complementary estimates of Soviet activity were available and appropriately documented."

NEED TO ASSESS U.S. NATIONAL SECURITY REQUIREMENTS

Finally, the foregoing discussion prompts the observation that the tendency to compare inputs to military programs between the U.S. and U.S.S.R. in addressing policy questions may beg a more fundamental question. That is, what sort of capabilities does the United States require to defend itself and its allies, and to carry out its foreign policy? Should we assume that required capabilities must be attained by matching inputs with our adversaries, or should we tailor our programs to provide specific outputs where we perceive the need for them?

IV. *U.S./U.S.S.R. Quantitative Force Comparisons: Cost Implications for Fiscal Year 1977 Budget*

Over the past 15 to 17 years, the U.S.S.R. has been committed to a policy of upgrading its military forces and firepower to achieve parity with the United States in commonly accepted measures of global power. The Soviet Union, through concentration and steady growth in defense expenditures, has advanced its technology for military purposes. Consequently, U.S. superiority in strategic forces which was unquestioned during the 1960's has been challenged by the U.S.S.R. in the 1970's.

UNACCEPTABLE DAMAGE

The overall strategic balance remains in favor of the United States. Because of America's capacity to inflict unacceptable damage on the U.S.S.R., and the uncertainty of the outcome of even limited military provocations, the Soviet Union is deterred from initiating hostile military action.

The proposed programs in the FY 1977 defense budget indicate the preferred direction of the Administration for U.S. military posture through the end of the 20th century. The recommended strategic and general purpose force strengths, when added to existing United States and allied force power, are intended to solidify NATO capability to defend against the Soviet Union and its allies.

SALT

Many welcomed the SALT agreements as a positive if not conclusive means of constraining the nuclear arms competition. Yet, since June 1972, both sides have improved the quality of their strategic systems, and the U.S.S.R. has continued to develop and deploy (a) a wide variety of ballistic missiles, (b) the Backfire bomber, and (c) assorted ships for an enhanced naval capability.

In the general purpose forces realm, the Soviet Union has expanded its force levels and added new equipment, especially tactical aircraft, artillery, and navy ships. Much of the new land and tactical air force strength has been deployed to the Sino-Soviet border to face the Chinese. At the same time, the Soviet Union's western-oriented forces have improved in terms of size and sophistication. The Soviet Navy is now capable of operating worldwide.

MILITARY BALANCE

The following force assessment of the military balance between the U.S. and U.S.S.R. focuses on the quantitative comparisons of men and equipment and the positioning of present NATO and Warsaw Pact forces. Major U.S. programs and costs proposed in the FY 1977 budget are identified within each mission area of strategic and general purpose forces. Further, the outyear implications resulting from FY 1977 budget proposals are also identified. No attempt is made to address the quality of forces. Not only is there difficulty in addressing such values, but the variables of conflict could render such compari-

sons invalid. The amounts indicated herein reflect the January 1976 budget request and do not include figures for subsequent budget amendments.

A. STRATEGIC OFFENSIVE FORCES

Table 1.—NUMBER OF STRATEGIC DELIVERY VEHICLES

	1975	
	United States	U.S.S.R.
Intercontinental ballistic missiles (ICBMs)-----	1,054	1,600
Submarine-launched ballistic missiles (SLBMs)-----	656	730
Total missile launchers-----	1,710	2,330
Intercontinental bombers ¹ -----	500	160
Total delivery vehicles ² -----	2,210	2,490
Total multiple independently targetable reentry launchers (MIRV launchers)-----	+925	110

¹ Includes deployed, strike-configured operational aircraft only.

² The total throw-weight of the delivery vehicles is approximately the same for both nations. The U.S.S.R. holds a sizeable lead in missile throw-weight which is offset by the U.S. lead in bomber payload capability. Throw-weight is defined as weight of missile above last boost stage with projected or programmed configurations 1,000's of pounds. Bomber payload is 1,000's of pounds representative aircraft loading rather than maximum or worst case.

Table 2.—NUMBER OF STRATEGIC NUCLEAR WEAPONS ¹

	United States	U.S.S.R.
Warheads and bombs:		
1972 ² -----	5,600	2,200
1975-----	8,500	2,500

¹ Online.

² Year of SALT I agreement.

INTERCONTINENTAL BALLISTIC MISSILES (ICBMs)

Soviet ICBM programs center around the older SS-7, SS-8, SS-9, SS-11, and SS-13 systems, many of which will probably be phased out during the next decade and replaced by the SS-X-16, SS-17, SS-18, and SS-19. The new ICBM family offers significant growth in target accuracy and multiple independently targetable reentry vehicle (MIRV) capability. There are indications that testing has been conducted on a land-based mobile capability for the SS-X-16; however, deployment in the near future appears unlikely.

U.S. ICBM programs are the Titan II (54), Minuteman II (450) and Minuteman III (550) missiles. Major development efforts in the DoD FY 1977 budget associated with the ICBM program are: (a) Minuteman (silo hardening, guidance, and target accuracy improvement), (b) M-X missile (advanced development of a new ICBM and mobile basing options), and (c) advanced ballistic reentry systems capability (ABRES). The costs for these efforts are:

Table 3.—UNITED STATES ICBM 1977 BUDGET PROPOSALS

[In millions of dollars]

	FY 76/7T and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
Minuteman-----	11, 450. 4	(804. 1)	471. 6	601. 3	214. 8	12, 738. 1
M-X-----	86. 2	(36. 0)	84. 0	¹ 184. 0	(²)	(²)
ABRES-----	1, 651. 1	(90. 8)	106. 0	¹ 117. 0	(³)	(³)

¹ Fiscal year 1978.² To be determined.³ Continuing development.**SUBMARINE-LAUNCHED BALLISTIC MISSILES (SLBMs)**

Soviet SLBMs currently in the force are the SS-N-5, SS-N-6, and SS-N-8, with the SS-NX-13 due to be operational in 1976. (The SS-NX-13 may not be utilized as a strategic missile.) There are five primary submarine launchers: Golf (diesel), Hotel II and III, Yankee, and Delta (a long Delta will become operational in 1976). The latter four submarines are all nuclear powered. The U.S.S.R. is also developing a new large and small SLBM for deployment in the 1978-79 period. The large missile will be the first Soviet SLBM with MIRV capabilities.

U.S. SLBMs are the Polaris A-3 and Poseidon; the Trident will become operational in 1979. Included in the U.S. figures are approximately 41 submarines carrying a total of 656 SLBMs with eventual capacity of 750-plus with the addition of Trident submarines. Both Trident and Poseidon have a MIRV capability.

The range capability of SLBMs is extremely important because it increases the patrol area for an adversary's anti-submarine warfare (ASW) fleet and makes their search problem more severe. The range capabilities of current United States SLBMs exceed capabilities of Soviet SLBMs except for the SS-N-8 and the two Soviet SLBMs currently in development. The range of the SS-N-8 (4000+ nautical miles) exceeds all existing submarines. The range of the Trident when fully operational will exceed that of all other SLBMs.

The Trident submarine and missile are the major items in the DoD FY 1977 budget associated with the SLBM program:

Table 4.—UNITED STATES SLBM's

[Costs in millions of dollars]

	FY 76/7T and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
Trident submarine:						
Cost-----	4,060.1	(983.1)	1,261.9	5,650.1	241.8	11,213.9
Quantities-----	4	(1)	1	6	-----	11
Trident missiles:						
Cost-----	2,893.1	(942.6)	1,671.1	4,618.5	966.4	10,149.0
Quantities-----	-----	-----	-----	-----	-----	600+

STRATEGIC BOMBER FORCES

The Soviet bomber force consists primarily of the Bison and Bear bombers and the Backfire bomber, particularly for the future U.S.S.R. bomber role. The Bison is also utilized as the primary tanker aircraft. To date, the Backfire has been deployed primarily with U.S.S.R. naval forces. It has the ability to reach the United States. The U.S.S.R. bombers are armed with the Kangaroo and Kitchen air-to-surface missiles (ASMs) and with stockpiled nuclear bombs.

The U.S. bomber force consists of 70 FB-111s and approximately 350 B-52s. The KC-135 represents the major tanker capability. Congress will decide this year whether to proceed with production of the B-1. The DoD FY 1977 budget provides funding for the initial buy of three B-1 production aircraft and long lead funding of eight FY 1978 aircraft. Current policy provides for an ultimate force of 240-plus B-1 aircraft. Assuming a favorable decision, the B-1 would become operational in significant numbers in the 1980's. Besides nuclear bombs, weapons to be carried by the B-1 and B-52 include the already deployed short-range attack missiles (SRAM) and the air-launched cruise missiles (ALCM) currently under development. A new buy of the SRAM missile is planned to provide B-1 armament. There are also advanced procurement funds in the FY 1977 budget for an advanced tanker/cargo aircraft (ATCA) with production to initiate in FY 1978. The ATCA will become the primary tanker for the B-1 and also be used for tactical forces purposes. Cost and quantities associated with strategic bomber forces and related systems in the FY 1977 budget are:

Table 5.—U.S. STRATEGIC BOMBER FORCES AND RELATED SYSTEMS

[Costs in millions of dollars]

	FY 76/77 and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
B-1:						
Costs.....	2,839.8	(660.5)	1,532.2	10,000.0	7,046.4	21,419.0
Quantities.....	3(R&D)		3	105	133	244
SRAM (B-1 procurement):¹						
Costs.....		(3.0)	36.3	838.4	402.3	1,280.0
Quantities.....				1,124	896	2,020
Air-launched/ cruise missile:²						
Costs.....	121.0	(50.1)	79.2	260.0		460.9
Quantities.....						
Advanced tanker/ cargo aircraft:³						
Costs.....	8.2	(5.2)	45.2	2,847.8	(⁴)	2,901.2
Quantities.....				41		41

¹ Previous SRAM procurements were for FB-111 and B-52 aircraft.

² The costs for the Air-Launched Cruise Missiles (ALCM) are R. & D. costs only.

³ Funded under general purpose forces.

⁴ Costs extend beyond FY 81.

B. STRATEGIC DEFENSE FORCES

The U.S.S.R. has far more strategic defensive forces than the United States, but the numbers are offset by the greater capabilities represented by U.S. low-altitude bombers and missiles. The Soviets have deployed strategic defensive forces because the U.S. strategic bomber force has always represented such a powerful threat in the U.S.S.R. The United States has significantly reduced its surface-to-air missile (SAM) and interceptor aircraft forces. Conversely, the U.S.S.R. has increased SAM development, particularly for low-altitude defense purposes. These efforts may produce some capability for defense against the SRAM and ALCM. There will be a slight reduction in U.S.S.R. interceptor aircraft although capability is projected to improve. Many of the deployed U.S.S.R. air defense systems were originally designed to counter medium- to high-altitude bombers and standoff threats imposed by the B-70 and its related technologies in development a decade ago.

Approximate 1975 figures for U.S. and U.S.S.R. are:

	United States	U.S.S.R.
Interceptor aircraft.....	420	2,600
SAM Launchers.....	0	¹ 9,600

¹ These launchers accommodate about 12,000 SAM interceptors.

Major items in the DoD FY 1977 budget associated with strategic defense forces and command and control systems related to strategic forces are (a) ballistic missile defense (R&D efforts, and technological improvements in sensors, data processing, radar, etc.), and (b) Advanced Airborne Command Post (AABNCP).

Table 6.—U.S. STRATEGIC DEFENSIVE FORCES

[Dollars in millions]

	FY 76/ 7T and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
Ballistic missile defense.	\$459.7	(\$197.2)	\$225.0	¹ \$241.2	Continuing development	
AABNCP:						
Costs.....	\$288.9	(\$42.0)	\$98.7	\$514.8	-----	902.4
Quantities.....	4	-----	-----	2	-----	6

¹ Fiscal year 1978.

C. THEATER NUCLEAR FORCES

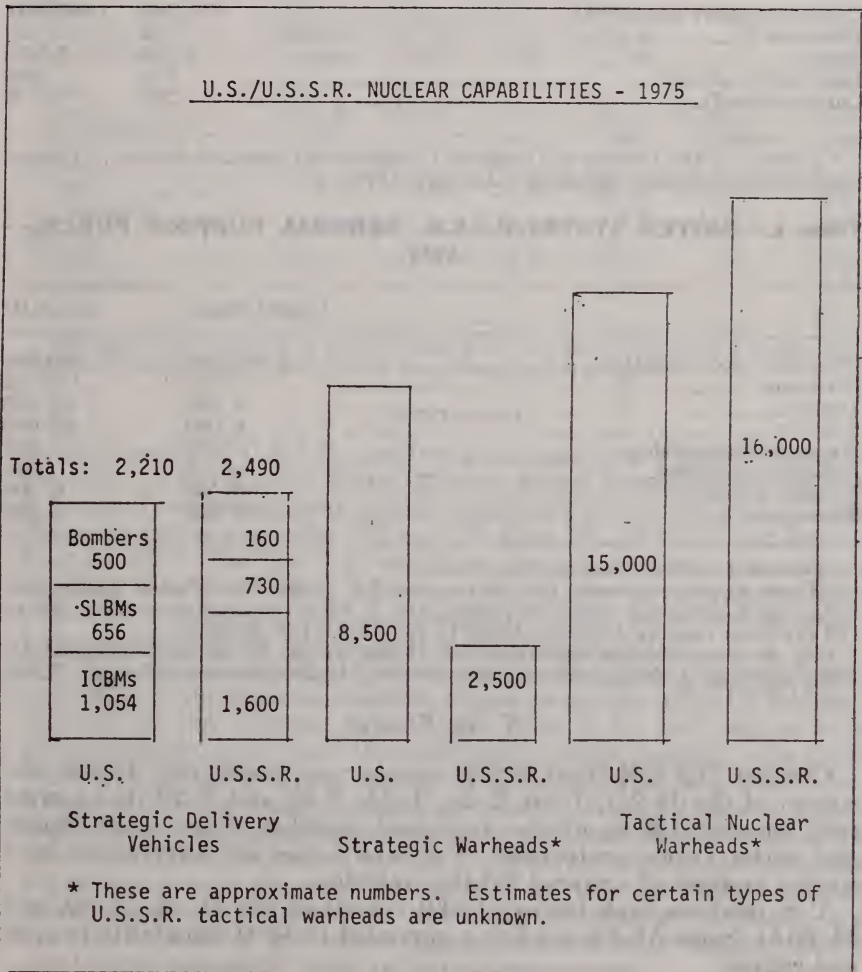
The primary purpose of theater nuclear weapons is to complement general purpose forces and act as part of a spectrum of deterrence and control of escalation. The theater nuclear forces of the U.S.S.R. land force consist of the SS-4 and SS-5 medium-range and intermediate-range ballistic missiles (MRBMs and IRBMs), and the Scud, Frog, and Scaleboard tactical missiles and rockets. Testing is being conducted on the SS-X-20, a MIRVed mobile IRBM. Several of the

U.S.S.R. tactical aircraft and a great number of their naval forces also are capable of tactical nuclear delivery, although the number of weapons is unknown.

U.S. theater nuclear forces are oriented toward nuclear-armed strike aircraft, atomic demolition munitions (ADMs), tactical surface-to-surface missiles (SSMs), and cannon artillery. Pershing, Lance, and Honest John are principal SSMs with the 8-inch and 155 mm cannon artillery comprising the nuclear artillery capability. The ASROC, SUBROC, Terrier, and Talos are basic naval force theater nuclear arms.

The Navy missiles have already incurred major procurement costs and the strike aircraft FY 1977 implications are discussed under tactical aircraft on page 162 of this study. There are several efforts underway to enhance theater nuclear force capability. None of the efforts have major impact on the FY 1977 budget.

The following chart illustrates the relative strengths of U.S./U.S.S.R. strategic and tactical nuclear capabilities:



D. GENERAL PURPOSE FORCES**Table 7.—NATO/WARSAW PACT BALANCE ¹**

	Northern and Central Europe	
	NATO	Warsaw Pact
Combat/support personnel-----	625, 000	895, 000
Divisions (does not include Reserves)-----	44	108
Tanks-----	7, 000	19, 000
Tactical aircraft-----	2, 300	2, 900
MRBM/IRBM-----	0	583
	Mediterranean flank	
	NATO	Warsaw Pact
Combat/support personnel-----	575, 000	345, 000
Divisions-----	39	31
Tanks-----	3, 500	7, 250
Land-based aircraft-----	733	655
Carrier aircraft-----	200	0

¹ A study by the Library of Congress, Congressional Research Service, "United States/Soviet Military Balance," January 1976.

Table 8.—UNITED STATES/U.S.S.R. GENERAL PURPOSE FORCES—1975

	United States	U.S.S.R.
Personnel (approximate)-----	2, 000, 000	¹ 3, 000, 000
Divisions-----	² 19	² 56-60
Tanks-----	9, 000	42, 000
Artillery-----	6, 000	19, 000
Major combatant ships-----	190	220
Attack submarines-----	80	260
Tactical aircraft-----	6, 500	6, 500
Helicopters-----	9, 000	2, 500

¹ Does not include para-military forces.

² These figures represent full active division units. The United States also maintains 8 complete reserve divisions; the U.S.S.R. maintains another 100 to 110 divisions ranging from one-third to two-thirds full divisions.

U.S. divisions average approximately 16,000 troops; Soviet divisions average: Tank division, 9,000; motorized rifle division, 11,500; airborne division, 7,200.

TANK FORCES

Current U.S.S.R. tank forces number approximately 42,000 and consist of the JS 2/3, T-10, T-54, T-55, T-62 and T-72 (the newest tank model with significant increased mobility, laser range finder, and better armor protection). The tank forces are augmented by a similar number of armored fighting vehicles.

U.S. medium tank forces (9,000) consist of the M-48, M-60, and M-60A1. Some M-48s are being upgraded to M-60 capability in guns and engine.

The M-60A1 is undergoing a product improvement program to incorporate a series of system enhancements in mobility, firepower, etc. In addition to this effort, the XM-1 tank is being designed and will provide improved armor protection and cross-country agility. The mechanized infantry combat vehicle (MICV) under development as a replacement for the M-113 armored carrier in some units will be used to complement the tank force for mobile combat purposes. Major items in the budget associated with tank forces are:

Table 9.—U.S. TANK FORCES

[Costs in millions of dollars]

	FY 76/77 and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
M-48 ¹ -----		(99.9)	61.9	310.2	-----	472.0
M-60A1:						
Cost-----	2,239.4	(511.3)	571.0	1,573.4	-----	4,383.8
Quantities-----	8,096	(800)	926	1,715	-----	10,737
XM-1:						
Cost-----	251.8	(52.2)	141.0	1,456.4	2,596.5	4,445.7
Quantities-----				822	2,490	3,312
MICV:						
Cost-----	63.8	(16.8)	29.9	388.4	276.4	758.5
Quantities-----				1,389	1,031	2,410
M-113:						
Cost-----	549.7	(61.1)	89.4	332.0	-----	971.1
Quantities-----						22,489

¹ A significant number of M-48 tanks were purchased prior to FY 76. These totals represent costs for current M-48 modernization program.

ARTILLERY

The number of U.S.S.R. artillery pieces and heavy mortars are double those of the United States. Recent Soviet developments indicate a change from towed field artillery systems to self-propelled systems. The new systems are the 122 mm SP Gun M-1974 and 152 mm SP Gun M-1973. The U.S.S.R. also has a series of surface-to-air missiles (SAMs), the SA-4, SA-6, SA-8, and SA-9. The Soviets deploy three anti-tank missile systems, the Snapper, Sagger and Swatter, which have ground/vehicle and/or helicopter firing capacity.

U.S. artillery and SAM development and procurement focuses primarily on the cannon-launched guided projectile (CLGP), SAM-D, Roland II, and Stinger. As SAM-D, Roland II, and Stinger enter the operational inventory, they will replace older systems such as the Nike-Hercules, Hawk and Improved Hawk, Chaparral, Redeye, and Vulcan. Basic anti-tank systems are the TOW and Dragon. A non-nuclear version of the Lance missile is proposed in the budget. The M-109A1, XM-204, and XM-198 are three howitzers with significant expenditures over the next few years. New U.S. air defense artillery developments are geared at providing all-weather, 24-hour, low-altitude capability and other system enhancements. Major items in the budget associated with artillery weapons are:

Table 10.—U.S. ARTILLERY

[Costs in millions of dollars]

	FY 76/77 and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
CLGP:						
Cost-----	45.6		36.1	497.6	660.4	1,239.7
Quantities-----						120,000
SAM-D:						
Cost-----	1,027.5	(130.3)	180.0	1,346.6	3,372.5	5,931.6
Quantities-----						5,000+
Roland:						
Cost-----	87.1	(55.0)	85.0	537.5	428.9	1,138.5
Quantities-----						5,000+
Stinger:						
Cost-----	116.7	(23.4)	71.5	504.3	227.5	920.1
Quantities-----						30,000+
Chaparral:						
Cost-----	414.4	(42.4)	65.8	65.9		546.1
Quantities-----						11,000+
Improved Hawk:						
Cost-----	914.9	(102.4)	107.1	138.0		1,160.1
Quantities-----						5,000+
TOW:						
Cost-----	951.8	(152.2)	109.2	106.6		1,167.6
Quantities-----						150,000+
Dragon:						
Cost-----	514.9	(146.7)	113.7	298.6	148.3	1,075.5
Quantities-----						130,000+
Lance (non- nuclear):						
Cost-----			75.7	79.6		155.3
Quantities-----						600+
Hellfire:						
Cost-----	29.8	(4.1)	17.3	140.4	577.3	764.8
Quantities-----						20,000+
M-109A1: ¹						
Cost-----			46.8	190.6		237.4
Quantities-----						500
XM-204:						
Cost-----	32.8	(14.0)	8.1	181.8	28.3	251.0
Quantities-----						1,600+
XM-198:						
Cost-----	54.2	(12.0)	16.6	175.3		246.1
Quantities-----						800+

¹ Figures represent current product improvement program only.

HELICOPTERS

The U.S.S.R. helicopter force lags substantially behind the U.S. force, 9,000 to 2,500. There are currently two major U.S.S.R. models, the HIND A (assault) and MI8/HIP (transport) helicopters. The United States is adding to its current helicopter force by developing the advanced attack helicopter (AAH) (ultimate inventory objective is 472) and utility tactical transport aircraft system (UTTAS) (ultimate inventory objective is 1100) for anti-tank and assault and transport purposes. The AAH will carry the Hellfire anti-tank missile and be an all-weather helicopter. Each of the two new helicopters have significantly improved performance criteria as a major system objective. Also in development is an advanced scout helicopter (ASH) for observation purposes. The AH-1J is undergoing modernization to prolong inventory life and accept the TOW missile. An extended range version of this helicopter is designated the AH-1S. Major items in the budget associated with helicopter acquisition are:

Table 11.—U.S. HELICOPTERS

[Costs in millions of dollars]

	FY 76/77 and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
AAH:						
Cost.....	196.5	(55.5)	112.1	993.1	1,575.8	2,877.5
Quantities.....				100	372	472
UTTAS:						
Cost.....	350.4	(91.9)	213.0	1,085.5	1,674.5	3,323.4
Quantities.....			15	359	733	1,107
ASH:						
Cost.....	12.7	(5.0)	26.0			
Quantities.....				(¹)		(¹)
AH-1J Cobra-TOW:						
Cost.....	802.5	(59.6)	128.9	257.5		1,188.9
Quantities.....	1,237	(30)	105	165		1,500

¹ Program scope currently under review.

NAVAL FORCES—SURFACE COMBATANT SHIPS

The U.S.S.R. has made significant strides in combatant ship quantities overtaking the United States by a slight margin in major surface combatants. Geared for flexibility with relatively new, well-armed, high-speed ships, the Soviet fleet is equipped with both offensive and defensive missile systems and modern electronic warfare capabilities. Particular emphasis is on anti-submarine warfare (ASW) and anti-ship missile capabilities. The composition of the force will soon consist of a missile ASW carrier, guided missile and gun cruisers, missile and

gun destroyers, and escorts. The Kiev-class aircraft carrier now nearing deployment will be the largest combatant developed in the U.S.S.R. Other current development or modernization efforts are for the Kara and Kresta II guided missile cruisers, the Krivak guided missile destroyer, and the Kashin guided missile frigate. All are equipped with ASW and/or SAM capability.

U.S. surface combatant ship capability centers on a mixed force of carriers, cruisers, guided missile and gun destroyers, and guided missile frigates and conventional frigates. This force is highly specialized to support carrier task force operations and protect resupply convoys. Consequently, emphasis has been placed on anti-submarine warfare (ASW) capabilities for escort ships. Carrier aircraft are intended to defend escorts from enemy surface ships and aircraft, and to support combat operations ashore. The current development strategy emphasizes high-speed, well-armed ASW, and anti-ship missile forces, a feature sought by the U.S.S.R. among its ships.

The United States plans to maintain a force of at least 12 attack carriers through the next decade. Current developments envision plans for a new class of carrier to replace the Midway/Forrestal class, new nuclear-powered strike cruisers, AEGIS destroyers, new patrol frigates, and surveillance ships. The AEGIS missile system for aircraft and missile detection, the HARPOON missile and sea-launched cruise missiles are the major equipment programs under development and production. Other armament acquisition efforts underway include the CAPTOR, improved MK46 torpedo, PHALANX, and standard missiles. A land-based system engineering development site is being constructed to support AEGIS ship development.

The DoD FY 1977 budget requests acquisition of 16 ships (4 submarines and 12 surface ships). The submarines are discussed in Submarine-Launched Ballistic Missiles (page 150) and Attack Submarine Forces (page 160). The 12 surface ships in the budget are eight guided missile frigates and one each of an AEGIS destroyer, fleet oiler, destroyer tender, and submarine tender. The budget seeks for full-funding of a conventionally powered destroyer and long leadtime funding for the nuclear-powered strike cruiser with its authorization to be in the FY 1978 budget. A total of eight conventional and two nuclear AEGIS ships are planned over the next 5-year period. The 5-year projections of the guided missile frigate total 40 ships. Major costs in the budget for surface ships and related programs and equipment include the following:

Table 12.—U.S. SURFACE SHIPS

[Costs in millions of dollars]

	FY 76/77 and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
AEGIS-Nuc Strike Cruiser:						
Cost-----	33.8	(15.6)	203.3	2,428.7	¹ 98.8	¹ 2,764.6
Quantities-----				2		2
AEGIS-Destroyer:						
Cost-----	20.2	(15.5)	869.5	4,038.0	¹ 114.0	¹ 5,041.7
Quantities-----			1	7		8
Guided Msl Frigate:						
Cost-----	1,384.6	(964.0)	1,288.5	5,338.4	464.1	8,475.6
Quantities-----	10	(6)	8	32		50
Destroyer Tender:						
Cost-----	395.1	(266.7)	315.3	606.4	30.7	1,347.5
Quantities-----	2	(1)	1	2		5
Sub. Tender:						
Cost-----	290.5	(.5)	263.2	15.0	15.7	584.4
Quantities-----	2		1			3
Fleet Oiler:						
Cost-----	245.9	(240.0)	102.8	792.5	55.1	1,196.3
Quantities-----	2	(2)	1	5		8
CVNX:						
Cost-----	8.5	(5.7)	11.5	¹ 3,750.4		¹ 3,770.4
Quantities-----				2		2
T-AGOS Surveil-						
lance:						
Cost-----	.4	.3	.5	391.9	18.6	411.4
Quantities-----				12		12
CSEDS:						
Cost-----	51.6	(45.0)	80.9	¹ 80.3		¹ 212.8
Quantities-----						

¹ Unspecified development and procurement continues beyond last FY period indicated.

Table 13.—U.S. SURFACE COMBATANTS'—WEAPONS & EQUIPMENT

[Costs in millions of dollars]

	FY 76/77 and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
HARPOON:						
Cost.....	583.7	(155.9)	186.0	656.9	-----	1,426.6
Quantities.....					-----	2,000+
SLCM:						
Cost.....	174.9	(93.7)	182.5	¹ 514.9	-----	¹ 872.2
Quantities.....					-----	
CAPTOR:						
Cost.....	149.0	(33.1)	73.0	463.3	113.9	799.2
Quantities.....					-----	1,200+
MK46:						
Cost.....	25.3	(11.2)	8.4	372.3	116.3	522.3
Quantities.....					-----	4,000+
Phalanx:						
Cost.....	96.6	(15.0)	38.9	330.4	279.3	745.2
Quantities.....					-----	250+
Standard Missile (Extended range):						
Cost.....	410.4	(69.3)	55.1	495.3	-----	960.8
Quantities.....					-----	4,000+
Standard Missile (Medium range):						
Cost.....	357.6	(44.5)	53.5	331.7	-----	742.8
Quantities.....					-----	4,000+
AEGIS System:						
Cost.....	503.9	(65.9)	26.3	57.0	-----	587.2
Quantities.....					-----	

¹ Unspecified development and procurement continues beyond last FY period indicated.

ATTACK SUBMARINE FORCES

Some Soviet attack submarines have only torpedoes for offensive weapons while others also have cruise missiles. The U.S.S.R. submarine force of about 250 attack submarines is the largest in the world; over one-half of the fleet is diesel-powered. Current U.S.S.R. development efforts for attack submarines focus on the Charlie-, Victor-, and Alfa-class nuclear-powered ships. The Foxtrot and Tango are the most significant conventional-powered submarines.

Cruise missile submarines include the Echo-, Charlie-, Papa-, and Juliett-class ships. Charlie has capability for submerged launch of SS-N-7 cruise missiles. New ASW missiles, the SS-N-15 and SS-NX-16 are thought to be capable of launch from a variety of the new Soviet attack submarines.

The U.S. attack submarine force will consist of a mixed force of nuclear- and conventional-powered submarines with major emphasis

on the nuclear-powered ships. The SSN-688 (currently in development) with superior quietness and improved sonar capability is intended to be the basic U.S. attack submarine. A submerged launched variant of the HARPOON and the sea-launched cruise missiles (SLCMs) will provide cruise missile capabilities for the submarine force. The MK-48 torpedo will also be utilized on attack submarine platforms. The major items in the budget for attack submarines are:

Table 14.—U.S. ATTACK SUBMARINES

[Costs in millions of dollars]

	FY 76/77 and prior	FY 76	FY 77	FY 78-81	Be- yond FY 81	Total
SSN-688:						
Cost-----	5, 492. 5	(618. 1)	1, 337. 5	2, 773. 5	92. 5	9, 696. 0
Quantities-----	28	(2)	3	8	-----	39
MK-48:						
Cost-----	1, 226. 8	(130. 8)	144. 3	579. 8	42. 2	1, 993. 1
Quantities-----	-----	-----	-----	-----	-----	3, 000+

TACTICAL AIRCRAFT FORCES

U.S.S.R. tactical aircraft fighter capability revolves around (a) the new generation MIG-21 Fishbed series, which doubles the weapons limit of previous versions and also extends its combat radius, (b) SU-17/Fitter C, with greater engine thrust and advanced avionics, (c) SU-19/Fencer-A, with a variety of guided and unguided air-to-ground missiles (AGMs), (d) MIG-23/Flogger, with increased performance package and armament over Fishbed, and (e) MIG-25/Foxbat B, with significant enhancements in altitude and speed. Primary U.S.S.R. aviation ordnance in future years will consist of the APEX, APHID, Kerry, and Kelt missiles. Estimated capabilities of these systems range from use against low-flying targets, use in short-range air superiority roles, and anti-radiation missile variants.

Significant power has been added to the U.S. tactical air forces by recent additions of the A-10, F-14, and F-15 aircraft. The F-16 and F-18 air combat fighters, when they become operational in the late 1970 and early 1980 timeframe, will further enhance U.S. air capability. Although quantities of U.S. tactical aircraft have diminished, the high-low mix of the new force is intended to bring sophisticated high performance to the force while maintaining force levels. This mix (F-14 and F-15 with F-16 and F-18) has the dual objective of air-to-air combat and air-to-ground combat capabilities.

Augmenting the newer aircraft are the older F-4, F-111, A-7, A-4M, and AV-8A, a vertical/short take-off land aircraft (V/STOL). The AV-8A will be phased out of the inventory by the new V/STOL, AV-8B). The F-111 will also be modernizing a portion of its fleet to an EF-111A configuration for electronic countermeasure jamming purposes. The A-6E will continue as an all-weather attack aircraft. The E-3A airborne warning and control system (AWACS) will provide all-altitude surveillance and command and control capability.

It is scheduled to become operational in CY 1976. The A-10, armed with Maverick missiles and laser-guided weapons, is being produced as a specialized close-air support aircraft. The Sparrow, Sidewinder, Shrike, Condor, Phoenix, and Harin (in development) missiles will provide a sizeable air-to-air-missile (AAM) and air-to-surface missile (ASM) capability for tactical air purposes.

There are many U.S. tactical air programs with significant acquisition costs proposed in the FY 1977 budget. Major items are:

AIR FORCE TACTICAL AIR

The Air Force intends to initiate a buy of F-16 aircraft with a planned inventory of 650. Four NATO nations have signed a memorandum of understanding to eventually purchase 306 F-16s with options to buy 348. A total of 108 F-15s (planned inventory 729) are in the budget; 100 A-10s (planned inventory 700-plus); and 6 E-3A AWACS (planned inventory 31). Major proposed FY 1977 funding includes:

Table 15.—U.S. AIR FORCE TACTICAL AIR PROGRAMS

[Costs in millions of dollars]

	FY 76/ 7T and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
F-16:						
Cost.....	317.4	(215.7)	619.7	4,791.8	325.8	6,054.5
Quantities.....			16	589	45	650
F-15:						
Cost.....	6,092.4	(1,602.4)	1,540.4	3,795.6		11,428.4
Quantities.....	296	(108)	108	325		729
A-10:						
Cost.....	1,036.3	(457.1)	617.8	2,550.7		4,204.8
Quantities.....	95	(53)	100	538		733
E-3A AWACS:						
Cost.....	1,833.0	(464.6)	584.3	1,337.8		3,755.1
Quantities.....	10	(4)	6	15		31
EF-111A:						
Cost.....	64.1	(4.8)	36.8	521.3		622.2
Quantities.....				40		40
F-4/F-111 Mods:						
Cost.....	814.7	(259.2)	262.5	1,183.2		2,260.4
Quantities.....						500+

NAVY TACTICAL AIR

The Navy budget proposes developmental effort on the F-18 to serve as a lower cost complement to the F-14 and replace the F-4/A-7 aircraft. Anticipated inventory objective is 800 aircraft. There is

also continued procurement of an additional 36 F-14s to the current inventory of 267 aircraft (planned inventory objective 391). Major budget proposals are:

Table 16.—U.S. NAVY TACTICAL AIRCRAFT

[Costs in millions of dollars]

	FY 76/77 and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
A-6 Mod to A-6E: ¹						
Cost-----	300. 0	(300. 0)	167. 9	614. 9	-----	1, 082. 8
Quantities-----						
A-7E:						
Cost-----	2, 021. 4	(178. 4)	235. 4	841. 4	-----	3, 098. 2
Quantities-----	542	(30)	30	120	-----	692
F-14:						
Cost-----	5, 323. 4	(621. 4)	708. 2	2, 194. 6	-----	8, 226. 2
Quantities-----	279	(36)	36	88	-----	403
F-18:						
Cost-----	152. 9	(110. 3)	346. 9	4, 059. 2	8, 272. 1	12, 831. 1
Quantities-----				117	683	800
A-4M:						
Cost-----	295. 7	(12. 7)	102. 4	63. 3	-----	461. 4
Quantities-----	120	-----	21	3	-----	153
P-3C:						
Cost-----	2, 053. 9	(172. 3)	241. 9	1, 331. 5	-----	3, 627. 3
Quantities-----	157	(12)	12	64	-----	233
E-2C:						
Cost-----	1, 162. 0	(161. 4)	170. 9	512. 1	-----	1, 843. 8
Quantities-----	43	(6)	6	18	-----	67
EA-6B:						
Cost-----	1, 460. 1	(115. 5)	139. 9	381. 5	-----	1, 981. 5
Quantities-----	66	(6)	6	18	-----	90
V/STOL:						
Cost-----	77. 0	(22. 0)	44. 0	² 416. 1	-----	537. 1
Quantities-----						(³)
LAMPS:						
Cost-----	104. 1	(26. 3)	83. 2	1, 406. 5	-----	1, 593. 8
Quantities-----				200	-----	200

¹ Includes current modifications of A-6 to A-6E configuration.

² Does not include potential costs beyond FY 1981.

³ Quantities undetermined.

Major proposed FY 1977 development and procurement efforts for both Navy and Air Force tactical air missiles are:

Table 17.—U.S. TACTICAL AIR MISSILES

[Costs in millions of dollars]

	FY 76/ 77 and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
Sparrow:						
Cost-----	767. 9	(143. 7)	156. 4	632. 0	417. 5	1, 973. 8
Quantities-----						25, 000+
Sidewinder:						
Cost-----	252. 7	(94. 5)	93. 2	366. 0	74. 9	782. 6
Quantities-----						17, 000+
Phoenix:						
Cost-----	848. 5	(101. 2)	84. 0	370. 6		1, 303. 1
Quantities-----						2, 500+
Shrike: ¹						
Cost-----	543. 3	(47. 0)	51. 3	217. 8		812. 4
Quantities-----						30, 000+
Condor:						
Cost-----	369. 5	(91. 0)	12. 7	180. 2		561. 4
Quantities-----						980+
Harm: ¹						
Cost-----	64. 4	(27. 7)	33. 5	498. 3		596. 2
Quantities-----						3, 800+
Maverick Laser:						
Cost-----	36. 3	(16. 6)	59. 3	213. 9		309. 5
Quantities-----						4, 500+
Maverick (Imaging Infra-red): ¹						
Cost-----	8. 2	(8. 2)	24. 0	621. 1		658. 3
Quantities-----						9, 600+

¹ Does not include potential costs beyond FY 1981.

AIRLIFT/SEALIFT FORCES

U.S. airlift/sealift forces provide capability to move forces rapidly to overseas theaters, meet commitments, and maneuver material in CONUS and overseas. The forces are separated into strategic and tactical airlift forces. Current strategic airlift capabilities revolve around the C-5A and C-141 military airlift fleets, which would be augmented by Civil Reserve Air Fleet (CRAF) aircraft under mobilization conditions. DoD plans to rebuild the C-5A wings, stretch the C-141, and modify a portion of the CRAF to increase its military cargo capacity. Tactical airlift capabilities revolve around the CH-53, US-3A carrier on-board delivery aircraft, CH-47 modification program, and the new development of the advanced medium STOL transport (AMST). Major items in the budget for airlift/sealift forces are:

Table 18.—U.S. AIRLIFT/SEALIFT FORCES

[Costs in millions of dollars]

	FY 76/77T and prior	FY 76	FY 77	FY 78-81	Beyond FY 81	Total
CH-47 Mod:						
Cost-----	18.9	(10.0)	25.9	338.7	967.0	¹ 1,350.5
Quantities-----				361		361
US-3A:						
Cost-----	24.3	(15.2)	170.9	199.7		394.9
Quantities-----			12	18		30
CH-53E:						
Cost-----	121.3	(10.5)	116.3	389.0		626.6
Quantities-----	4		10	60		74
AMST:						
Cost-----	207.2	(84.9)	29.3	¹ 90.0		¹ 326.5
Quantities-----						(²)
C-5A Wing MOD:						
Cost-----	405.0	(22.3)	22.6	500.1	528.7	1,091.9
Quantities-----				38	38	76
C-141 Stretch MOD:						
Cost-----	41.5	(16.5)		601.3	38.1	680.9
Quantities-----				274		274
CRAF MODS:						
Cost-----			29.3	463.1	307.6	800.0
Quantities-----			6	75	29	110

¹ Does not include all potential costs beyond year specified.² Quantities have not been specified.**E. WESTERN PACIFIC/ASIA DEPLOYMENT**

Both the U.S. and U.S.S.R. maintain a large contingent of forces and weaponry in the Western Pacific/Eastern Asia region. The Soviet buildup consists of 28 army divisions added to the forces over approximately the past 15 years. This buildup is a direct result of concern over the Sino-Soviet split during the 1960's. Altogether, the U.S.S.R. maintains 43 divisions and 2 brigades along the Chinese border and on Sakhalin Island and the Kamchatka Peninsula. These forces are geared for action against China. The Soviet naval force consists of strategic and attack submarines and surface ships. Its air force consists of approximately 1,700 combat aircraft.

The presence of U.S. troops in the Pacific area is intended to deter hostilities, to maintain a stable military and political balance, and to honor commitments to allies. U.S. forces deployed in the Western Pacific area are comprised of 1 Army division, the equivalent of 1 Marine division, 9 tactical aircraft squadrons, 2 carrier task forces, and patrol aircraft squadrons. Forces stationed in Hawaii include an additional Army division and a tactical aircraft squadron. Forces based in the Western United States could augment these deployed forces but are not maintained exclusively for an Asian contingency. Major U.S. force commitments in the Pacific are located in Hawaii, South Korea, Guam, Japan, including Okinawa, and the Philippines.

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